C 4

Indiana Law Review

VOLUME 15 • 1982 • NUMBER 2

Dedication

R. Bruce Townsend

Articles

Secured Creditors Under the Bankruptcy Reform Act
Frank R. Kennedy

Confirmation of a Plan Under Chapter 11 of the Bankruptcy Code and the Effect of Confirmation on Creditors' Rights
Edward B. Hopper, II

When Can the Owners Participate in the Reorganized Debtor?: Cram Down as a "Shield" for Creditors
James M. Carr

The Plight of the Defaulting Mortgagor
Sigmund J. Beck

Secured Claims Under Section 1325(a)(5)(B): Collateral Valuation, Present Value, and Adequate Protection
S. Andrew Bowman
William M. Thompson

Note

The Continuing Vitality of *Louisville Joint Stock Land Bank v. Radford:* Persuasive Authority for Cases Declaring Retroactive Application of Section 522(f) of the Bankruptcy Code Unconstitutional

Forthcoming in the Indiana Law Review:

Indiana Juvenile Law: Recent Developments

Taxation of Personal Service Corporations

Negligent and Intentional Infliction of Emotional Distress

The Indiana Death Penalty Statute

Indiana Law Review

Volume 15 | 1982 | Number 2

Dedication

R. Bruce Townsend

Articles

Secured Creditors Under the Bankruptcy Reform Act
Frank R. Kennedy 477

Confirmation of a Plan Under Chapter 11 of the Bankruptcy Code and the Effect of Confirmation on Creditors' Rights *Edward B. Hopper, II* 501

When Can the Owners Participate in the Reorganized Debtor?: Cram Down as a "Shield" for Creditors
James M. Carr 547

The Plight of the Defaulting Mortgagor *Sigmund J. Beck* 561

Secured Claims Under Section 1325(a)(5)(B): Collateral Valuation, Present Value, and Adequate Protection
S. Andrew Bowman 569
William M. Thompson

Note

The Continuing Vitality of *Louisville Joint Stock Land Bank v. Radford*: Persuasive Authority for Cases Declaring Retroactive Application of Section 522(f) of the Bankruptcy Code Unconstitutional 593

Volume 15 | Spring 1982 | Number 2

The INDIANA LAW REVIEW (ISSN 0090-4198) is the property of Indiana University and is published four times yearly, January, March, April, and June, by the Indiana University School of Law—Indianapolis, which assumes complete editorial responsibility therefor. Subscription rates: one year $15.00; foreign $18.50. Single copies: annual Survey issue, $9.00; other issues, $4.50. Back issues are available from Fred B. Rothman & Co., 10368 W. Centennial Rd., Littleton, Co. 80123. Please notify us one month in advance of any change of address and include both old and new addresses with zip codes to ensure delivery of all issues. Send all correspondence to Editorial Assistant, Indiana Law Review, Indiana University School of Law—Indianapolis, 735 West New York Street, Indianapolis, Indiana 46202. Publication office: 735 West New York Street, Indianapolis, Indiana 46202. Second class postage paid at Indianapolis, Indiana 46201.

Please enter my subscription to the
INDIANA LAW REVIEW

NAME ______________________________

ADDRESS ______________________________

____

____

Enclosed is $______ for ____ subscriptions.

Bill me for ______ subscriptions.

Mail to:

INDIANA LAW REVIEW
INDIANA UNIVERSITY
SCHOOL OF LAW—INDIANAPOLIS
735 West New York Street
Indianapolis, Indiana 46202

Subscription Rates (one year):

Regular, $15.00; Foreign, $18.50; Survey, $9.00

Indiana Law Review

Volume 15 1982

Indiana University School of Law—Indianapolis

1981-1982 ADMINISTRATIVE OFFICERS AND FACULTY

Administrative Officers

JOHN W. RYAN, *Ph.D., President of the University*
GLENN W. IRWIN, JR., *M.D., Vice-President*
GERALD L. BEPKO, *LL.M., Dean*
G. KENT FRANDSEN, *J.D., Associate Dean for Student Affairs*
JEFFREY W. GROVE, *J.D., Acting Associate Dean for Academic Affairs*

Faculty

THOMAS B. ALLINGTON, *Professor. B.S., University of Nebraska, 1964; J.D., 1966; LL.M., New York University, 1971.*

EDWARD P. ARCHER, *Professor. B.M.E., Rensselaer Polytechnic Institute, 1958; J.D., Georgetown University, 1962; LL.M., 1964.*

JAMES F. BAILEY, III., *Associate Professor and Director of Law Library. A.B., University of Michigan, 1961; J.D., 1964; M.A.L.S., 1970.*

GERALD L. BEPKO, *Dean and Professor. B.S., Northern Illinois University, 1962; J.D., IIT/Chicago-Kent College of Law, 1965; LL.M., Yale University 1972.*

CLYDE HARRISON CROCKETT, *Professor. A.B., University of Texas, 1962; J.D., 1965; LL.M., University of London (The London School of Economics and Political Science), 1972.*

DEBRA A. FALENDER, *Associate Professor. A.B., Mount Holyoke College, 1970; J.D., Indiana University, 1975.*

G. KENT FRANDSEN, *Associate Dean for Student Affairs and Associate Professor. B.S., Bradley University, 1950; J.D., Indiana University, 1965.*

DAVID A. FUNK, *Professor. A.B., College of Wooster, 1949; J.D., Case Western Reserve University, 1951; M.A., The Ohio State University, 1968; LL.M., Case Western Reserve University, 1972; LL.M., Columbia University, 1973.*

PAUL J. GALANTI, *Professor. A.B., Bowdoin College, 1960; J.D., University of Chicago, 1963.*

HELEN P. GARFIELD, *Professor (on leave first semester, 1981-82). B.S.J., Northwestern University, 1945; J.D., University of Colorado, 1967.*

HAROLD GREENBERG, *Associate Professor. A.B., Temple University, 1959; J.D., University of Pennsylvania, 1962.*

JEFFREY W. GROVE, *Acting Associate Dean for Academic Affairs and Professor. A.B., Juniata College, 1965; J.D., George Washington University, 1969.*

WILLIAM F. HARVEY, *Carl M. Gray Professor of Law. A.B., University of Missouri, 1954; J.D., Georgetown University, 1959; LL.M., 1961.*

W. WILLIAM HODES, *Assistant Professor. A.B., Harvard College, 1966; J.D., Rutgers, Newark, 1969.*

LAWRENCE A. JEGEN, III., *Professor. A.B., Beloit College, 1956; J.D., The University of Michigan, 1959; M.B.A., 1960; LL.M., New York University, 1963.*

HENRY C. KARLSON, *Associate Professor. A.B., University of Illinois, 1965; J.D., 1968; LL.M., 1977.*

WILLIAM ANDREW KERR, *Professor (on leave, 1981-82). A.B., West Virginia University, 1955; J.D., 1957; LL.M., Harvard University, 1958; B.D., Duke University, 1968.*

WALTER W. KRIEGER, *Associate Professor. A.B., Bellarmine College, 1959; J.D., University of Louisville, 1962; LL.M., George Washington University, 1969.*

DAVID P. LEONARD, *Assistant Professor. B.A., University of California at San Diego, 1974; J.D., UCLA School of Law, 1977.*

WAYNE K. LEWIS, *Assistant Professor. B.A., Rutgers University, 1970; J.D., Cornell Law School, 1973.*

WILLIAM E. MARSH, *Associate Professor. B.S., University of Nebraska, 1965; J.D., 1968.*

SUSANAH M. MEAD, *Assistant Professor. B.A., Smith College, 1969; J.D., Indiana University, 1976.*

MARY H. MITCHELL, *Assistant Professor. A.B., Butler University, 1975; J.D., Cornell Law School, 1978.*

RITA M. NOVAK, *Assistant Professor. B.A., Albion College, 1972; J.D., De Paul University, 1978; LL.M., Columbia University, 1981.*

MELVIN C. POLAND, *Professor. B.S., Kansas State University, 1940; LL.B., Washburn University, 1949; LL.M., The University of Michigan, 1950.*

RONALD W. POLSTON, *Professor. B.S., Eastern Illinois University, 1953; LL.B., University of Illinois, 1958.*

GARY A. RATNER, *Associate Professor. B.S., California Institute of Technology, 1966; M.S., Purdue University, 1969; J.D., University of Connecticut, 1973, LL.M., Yale University, 1974.*

BRYAN M. SCHNEIDER, *Assistant Professor. B.A., Amherst College, 1973; J.D., University of South Carolina School of Law, 1976; LL.M., Yale Law School, 1980.*

MARSHALL J. SEIDMAN, *Professor (on leave, 1981-82). B.S., University of Pennsylvania, 1947; J.D., Harvard University, 1950; LL.M., 1970.*

KENNETH M. STROUD, *Professor. A.B., Indiana University, 1958; J.D., 1961.*

BRADLEY J. TOBEN, *Assistant Professor. B.A., University of Missouri, 1974; J.D., Baylor University School of Law, 1977; LL.M., Harvard Law School 1981.*

JAMES W. TORKE, *Professor. B.S., University of Wisconsin, 1963; J.D., 1968.*

R. BRUCE TOWNSEND, *Cleon H. Foust Professor of Law. A.B., Coe College, 1938; J.D., University of Iowa, 1940.*

JAMES PATRICK WHITE, *Professor (on special assignment). A.B., University of Iowa, 1953; J.D., 1956; LL.M., George Washington University, 1959.*

LAWRENCE P. WILKINS, *Associate Professor. B.A., The Ohio State University, 1968; J.D., Capital University Law School, 1973; LL.M., University of Texas School of Law, 1974.*

HAROLD R. WOODARD, *Professorial Lecturer. B.S., Harvard University, 1933; J.D., 1936.*

WILLIAM J. WOODWARD, *Assistant Professor. B.A., University of Pennsylvania, 1968; J.D., Rutgers-Camden, 1975.*

Emeriti

AGNES P. BARRETT, *Associate Professor Emeritus. B.S., Indiana University, 1942; J.D., 1964.*

CLEON H. FOUST, *Professor Emeritus. A.B., Wabash College, 1928; J.D., University of Arizona, 1933.*

JOHN S. GRIMES, *Professor Jurisprudence Emeritus. A.B., Indiana University, 1929; J.D., 1931.*

Legal Writing Instructors

PATRICIA SEASOR BAILEY, *Lecturer. B.A., Anderson College, 1978; J.D., Indiana University, 1981.*

CLARK ROBINSON, *Lecturer. A.B., Earlham College, 1966; M.A., Southern Illinois University-Carbondale, 1968; J.D., Indiana University, 1981.*

JOAN RUHTENBERG, *Lecturer. B.A., Mississippi University for Women, 1959; J.D., Indiana University, 1980.*

Law Library Staff

WENDELL E. JOHNTING, *Technical Services Librarian. A.B., Taylor University, 1974; M.L.S., Indiana University, 1975.*

LAURA KIMBERLY, *Acquisitions/Serials Librarian. B.A., Florida State University, 1977; M.S., 1980.*

CHRISTINE L. STEVENS, *Reference Librarian. A.B., Western Michigan University, 1970; M.L.S., Indiana University, 1971.*

KATHY J. WELKER, *Assistant Director. A.B., Huntington College, 1969; M.L.S., Indiana University, 1972.*

MERLIN P. WHITEMAN, *Reader's Service Librarian. A.B., Hope College, 1973; M.L.S., Indiana University, 1974.*

This issue of the Indiana Law Review is fondly dedicated to Professor R. Bruce Townsend on the occasion of his retirement.

My Tribute To R. Bruce Townsend

It is my privilege to pay tribute to R. Bruce Townsend, Professor of Law, Indiana University School of Law, Indianapolis.

Literally thousands of young lawyers have benefited from his instructions. He has firmly held to the principle that the law is a discipline worthy of ethical practice. Adherence to the law and improvements to the law were cardinal virtues which he sought to instill in his students.

He is noted for inspiring his students and they have responded with loyalty to him. He has received numerous special awards from his students and the law school. His tenure as a mentor has been rewarded by the phenomenal success of many of his students. He has indeed had an illustrious career. It is my sincere hope—whatever pursuits he may follow in his retirement—that they will be as productive and rewarding as his tenure as a teacher of the law.

Words are somehow inadequate to express fully my admiration and respect for Professor R. Bruce Townsend.

DONALD H. HUNTER
Justice, Indiana Supreme Court

R. Bruce Townsend

I believe that no reasonable man would question that there is something different, if not unique, about a law professor who would sit in his office with an automobile hub cap perched atop his head, while awaiting student conferences.

I believe, also, that no reasonable man would deny the resourcefulness of any such professor who, when pressed for an explanation for his unorthodox behavior, could reply, with complete plausibility, that he was testing his students for awareness, curiosity, aggressiveness of spirit, directness, and diplomacy.

"The potentially great lawyers," he declares, "will notice and wonder. Then, with no qualms whatever, will look me straight in the eye and ask, without giving the slightest offense, 'Why in the hell are you wearing that hub cap?' "

"The ones who are completely absorbed in the question they came to ask and do not even notice the strange head gear will probably become legal scholars and writers."

"Those who notice and wonder but are reluctant to inquire for fear of offending would, in a bygone era, have been prime candidates for the diplomatic corps but, in this age, will become successful book salesmen; while those who observe and have their curiosity piqued, but resort to inquiry of others for their enlightment, will be the investigators and adjusters."

As if by afterthought, he concludes, "Those who observe the curiosity but merely grunt or look away, knowing full well that I am never to be regarded as anything but a buffoon, they will become judges."

What manner of man is this R. Bruce Townsend? You will observe, from the above, that with the possible exception of those who make hasty judgments, Bruce sees the potential for every law student to be a "good" something. Perhaps it is this talent for the visionary that has inspired him and enabled him to touch the lives of young people.

I was well acquainted with Bruce before I knew him. That is to say that I was familiar with some of his works and with his reputation as a scholar, teacher, and writer for some considerable period of time before I met him in person. I do not recall when the latter occurred, which is expositive only of my memory and in no way indicative of the impression it made upon me. Probably, I was awed at the thought of meeting someone of such prominence in legal circles. If so, my veneration soon subsided. How can you revere one whose entire being exudes friendship and says, "Let's enjoy each other?" It seems that I have always known Bruce and that he has always been my friend.

It would serve no purpose to recount here Bruce's numerous contributions to the bench, bar, and academe of Indiana. I have never known him to refuse a request, whether it was merely to give counsel to a panicked young lawyer, to lecture at a seminar, or to write an article for a journal. His years of unselfish service and uncountable contributions to the legal community of this state, from both an academic and a practice standpoint, cannot be overstated. His special efforts and success with regard to the drafting and adoption of the Uniform Commercial Code and the Indiana Code of Civil Procedure are of particular note and evidence his keen perception and dedication to what the law should be—as well as to what it is.

It is my judgment, however, that the benefits derived by us from his efforts in those areas are mere by-products of his professional career. His true worth can be measured only by the knowledge he has imparted, by the values he has imbued, and by the will to challenge all that he has implanted into the minds of literally hundreds of practicing lawyers, many of whom are, or will become, prominent and influential citizens of their respective communities. The quality of his ability to influence and inspire young people is unsurpassed.

When I reflect upon my own law school days—forty-odd years ago—and upon my early years in the practice, one professor still stands out as the one who "put it all together" and made it all seem not only worthwhile but exciting, and he had a profound influence upon my life and career. When I visit today with those of the court research clerks who attended the Indiana University, Indianapolis Law School, it is Professor Townsend whom they remember and refer to with the reverence and affection that I still hold for my mentor.

Whether innately or by years of unrelenting effort, Bruce unquestionably is possessed of that elusive talent, difficult to define but easy to recognize, for communicating with and becoming close to law students. We are fortunate, indeed, that he elected to utilize his skills in a manner so beneficial to our society.

Because I know Bruce initimately, I know things about him that perhaps he does not know himself. For example, I know that law students have been his life. I know that he has agonized over his decision to retire at this time. I know that he questions the adequacy of his energy to perform, indefinitely, at par excellence, in the strenuous game he selected for his life's work. And I know that he believes, as I do, that it is better to leave the party a little early than to stay too late.

Personally, I never believed Bruce's account of why he wore the hub cap. I confess that I am prone to make snap judgments, and, had

I witnessed such outlandish behavior in anyone but him, my conclusion would have been precisely what he intimates. However, I do know Bruce, and I know why he did it. It was for the simple reason that that is what he felt like doing that day. It was upon that same occasion that he began to think of retiring. It felt so good!

So Bruce, thank you for your devoted and benevolent service, and thank you for being our friend. May you wear your hub cap in prosperity and good health.

DIXON W. PRENTICE
Justice, Indiana Supreme Court

On Bruce Townsend

Bruce Townsend is a brilliant law teacher. For nearly forty years he has provided stimulation and has caused students to be interested in and excited about his subjects. Judging from all reports he was an extremely effective teacher in those days when World War II veterans returned to civilian life to attend law school in the late 1940's and early 1950's. He had a profound impact on those students and on those who came to the School in years following. In the past ten years I have watched him capture the imagination of each new wave of students who still flock to his classes and develop a profound affection for him. I know of no other teacher who has touched so many lives.

Bruce's teaching includes an extra dimension for Indiana lawyers. He has prepared written materials of various kinds which he has distributed in his courses. Some of these materials have been used by lawyers in practice. It is not unusual for lawyers and judges to make reference to Bruce's materials and I have heard lawyers say that they have settled important cases based on what was found in them.

Bruce has also had an extraordinary impact on the advancement of the law and its practice in Indiana. As a member of the Conference of Commissioners on Uniform State Laws he helped draft the Uniform Commercial Code and was instrumental in having Indiana become one of the early adopting states in 1962. He was also instrumental in the revision of the Indiana Rules of Trial Procedure and he played a significant role in Indiana's adoption of the Uniform Consumer Credit Code. His work on these major developments has provided an extraordinary contribution to the State of Indiana and has added an important extra quality to his work in the classroom.

Bruce has made an extraordinary contribution to the state through his service to the profession. Over the years he has been a superb lecturer in Continuing Legal Education Programs. I have worked personally with him in this type of forum and can testify that there are few lecturers who provide as much insight for lawyers or who are more popular than Bruce. I have seen him hold a group of lawyers spellbound. Moreover, Bruce makes himself available for questions from lawyers both at CLE programs and in his office. My estimate is that he receives nearly 1,000 phone calls per year seeking his advice on research issues. To the best of my knowledge he has never charged a fee for his consultation even though I am confident that there have been millions of dollars involved in the cases in which he has been asked advice. For example, in one case which was brought to my attention by a lawyer, Bruce actually dashed off a memorandum which gave the lawyers an ap-

proach which preserved an $11 million financing arrangement.

Bruce is also a splendid colleague. He has worked long hours to uphold many parts of our law program. Even today he is often present at student functions and makes financial contributions to student activities that are unparalleled. He has always been available to help colleagues, particularly new teachers, and he played a major role in arguing the case for a new law building at Indianapolis in the 1960's.

Finally, Bruce is a good friend. I have come to know him well in the ten years that I have been at Indiana University. This has been a joy and honor for me. We all love him and we will miss him very much when he retires.

GERALD L. BEPKO
Dean, Indiana University
School of Law—Indianapolis

R. Bruce

Give me a log hut;
with only a simple bench;
Mark Hopkins on one end
and I on the other,
and you may have all
the buildings, apparatus
and libraries without him. –

Some people at some time could perhaps sit around on logs endlessly informing others, but today's law teacher cannot. Were Mark Hopkins today imparting law to his students, he probably would be hopelessly out of date. Such is the penalty for any revolt against the grinding servitude to advance sheets and their accompanying blizzard of current commentary. Lest the reader assume these words are being written by one who no longer gives a darn about professional competence, I hasten to add that I am merely trying to make the point that the work ethic was probably invented, albeit reluctantly, by a productive law professor.

And the corollary to that point is that while much is made of Bruce Townsend's propensity for hubcaps, he really should have collected anvils, if anvils are an appropriate symbol of the work ethic. One of my earliest recollections of the "Indianapolis Division" of the Indiana University School of Law is that of the Saturday Regulars: Bruce, Dean Witham and Ben, later Dean, Small. After five days of study and research and at least three nights of teaching, those three could regularly be found in their offices on Saturday. Early on, this produced for Bruce an excellent 98 page article, *Creation of Joint Rights Between Husband and Wife in Personal Property*,[2] and for Ben, *Workmen's Compensation Law of Indiana*.[3]

I suspect that Bruce's schedule has not varied a great deal since then. This accounts for his storehouse of knowledge about the law in general and his intricate knowledge of its Indiana applications.

I have thought that law professors if classified by their chief instructional resources would fall into two main classifications, of course with many variables: the eclectics who tend to rely upon commentary, and the purists, like Bruce, whose first resource is case analysis and synthesis. The latter requires a high quality of case

---

[1]James A. Garfield, then a member of the U.S. House of Representatives from Ohio, to Williams College Alumni in New York City, Dec. 2, 1871. Mark Hopkins was then President of Williams College.

[2]52 Mich. L. Rev. 779 (1954).

[3]B. Small, Workmen's Compensation Law of Indiana (1950).

recall which Bruce has; suggestion of any fact situation will generally produce from memory the volume and page of an Indiana case in point. Fine-tuned case analysis together with a capacity for organization, a slightly arcane sense of humor, and an ever-stimulating presentation made him a great teacher by anybody's standards.

Have we just described a pedant? Not really, but just in case this *ragout* needs a few more ingredients, add a weakness for shiny machinery, preferably about 12 cylinders, a good to excellent golf game, a middling to fair fishing skill, and a tolerant and loving family.

If the total describes a fellow you would like to know, then it is reasonably accurate.

And by and large, if there is any moral to this description it is not a new one, but one straight from Poor Richard[4]—diligence pays.

CLEON H. FOUST
Dean Emeritus, Indiana University
School of Law—Indianapolis

---

[4]Not Richard Bruce Townsend.

Some Reflections on the Retirement of Professor R. Bruce Townsend

The retirement of a law professor of the stature of Bruce Townsend triggers a tangle of reactions for one who has known him and counted him a friend since the time Bruce was a graduate student in Bloomington, Indiana in the late '30s.

Since he has indicated that he is not only retiring but will be moving from our community, the first reaction, of course, is that he will be missed. His warm and friendly (if sometimes eccentric) personality, gentle (if sometimes sardonic) sense of humor and sincere concern for others which he brought to his work and his life in general are rare attributes which have endeared him over the years to students, fellow lawyers, judges and his many, many other friends.

It is difficult to pick out just a few things about Bruce that stand out in one's memories of more than forty years of association. There are, however, three that, to me, are of particular significance.

First, Bruce, above all else, is a teacher. He loves all aspects of the law and is excited by changes and new developments whether he personally regards them as good or bad. He is an in-depth researcher and competent writer, but I think his greatest joy has been found in the hours he stood before a class and indulged his creativity in finding new ways to stretch the minds of his students.

An aspect of his teaching life that must give him great satisfaction is the rapport that he developed with students, which then continued after his students became lawyers in their own right. Many of his former students still call him for advice, and I understand it is not uncommon for Bruce to be able to provide case and statutory citations in the course of a phone call which otherwise might have taken hours to run down in a library or which might even have been missed entirely.

Second, I think Bruce made a truly great contribution to his profession in his work as a Commissioner of Uniform State Laws in drafting and supporting the enactment of the Uniform Commerical Code. Thereafter, he went the "extra mile" in explaining this complex piece of legislation to the practicing Bar and the business community. He, with Professor Pratter of the Bloomington Law School, wrote a very scholarly commentary on the Code and together and separately they devoted uncounted hours to presenting seminars and talks and generally educating the legal and commercial community as to the import and technicalities of the new law.

Third, Bruce may have made his greatest contribution to the legal profession and to the judicial system in serving as Reporter for the Indiana Civil Code Study Commission which produced the Indiana Rules of Civil Procedure which became effective in 1970. As

Reporter, he did much of the required research himself and directed the research of the Commission staff. He had much to do with the structure of the Rules and was a very forceful influence as to their content.

In the course of his work, he prepared draft after draft of various sections and subsections, always thoroughly and with good grace despite the fact that he was performing this large task in addition to carrying a full teaching load. Not every provision that Bruce proposed to the Commission was accepted, as his zeal for what he considered needed law reform caused him to seek to include some matters which the more conservative (and perhaps less enlightened) lawyers and judges making up the Commission felt belonged elsewhere, if anyplace, in Indiana jurisprudence. However, Bruce fought for his position with skill and perception and earned the unqualified respect of each Commissioner. The official comments to the Rules are in large part his work product.

As indicated earlier, there are so many lives that Bruce has touched, so many people that he has helped, so many accomplishments to his credit as lawyer and teacher, that a few words cannot possibly accord him full recognition. Others will be commenting on the man, the lawyer, the scholar and the teacher, however, and it is my hope that out of the collection of brief essays, prepared on the eve of Bruce's retirement, at least something like a complete portrait will emerge.

Let me close my personal reflections by saying to Bruce, "Congratulations on many jobs well done and on a career which surely has been as satisfying to you as it has been meaningful to your constituents. Please return from time to time from the quiet with which you and your lovely Rachel intend to surround yourselves and share with us again your wisdom, insight, and humor."

C. B. DUTTON
Senior Partner, Dutton, Kappes, & Overman

In Re the Alleged Retirement of R. Bruce Townsend

I do not for one moment believe that R. Bruce Townsend is going to retire. Such a thing is as unthinkable as the Statue of Liberty suddenly sitting down to take a break. Professor Townsend may *say* he is going to retire and even go through the motions, but let him hear of an opportunity to teach and, like the old firehouse dog hearing the fire bell, he'll shortly thereafter be waving his arms and drawing figures on the blackboard before an astonished and awed audience.

I first met Professor Townsend when I began my teaching career at the Indiana University, Indianapolis Law School in January, 1970. I quickly became aware of what a special member of the faculty he was. His history included being a drafter of the Uniform Commercial Code; he was the guiding spirit behind Indiana's adoption of the Rules of Civil Procedure, and his phone constantly rang with calls from former students who were now judges, legislators, or lawyers needing his wisdom. He also stood out in other ways. I have seen him deliberately vote against his own motion in faculty meetings; I have stood apprehensively on the sidewalk while he dashed into the street to capture a muffler that had fallen off a passing car ("Why would anyone abondon this?" he would ask, perplexed —planning to clean it up and use it for decorative purposes). He is color-blind, and I remember the first time I was invited to his house and met his lovely wife Rachel. She greeted me warmly, and then surveyed R. Bruce's brown sports coat, pink shirt, and bright blue tie and said sorrowfully, "Oh, Bruce, you got out of the house this morning without me checking you over first."

When I began teaching Commercial Law, Professor Townsend became my guide and mentor. No one in the world knows as much about commercial legal problems and their resolution as R. Bruce Townsend, and he was ever willing to share his vast storehouse of knowledge with neophytes like myself (I called him at his home one evening during a ten minute break from a two hour class to ask if "order language" was needed when naming a "special indorsee" on commercial paper[1]).

When talking about his early days as an advisor to the committee drafting Article 9 (Secured Transactions) of the Uniform Commercial Code, R. Bruce's eyes would glisten and he would say, with wonder in his voice, "Doug, can you imagine what it was like to be a young man sitting at the feet of the great Karl Llewellyn as he

---

[1]The answer is no.

pulled together the forces that led to the Uniform Commercial Code?" R. Bruce was very proud of his own contributions to the Code (for example, being the first person to suggest that the statute of frauds ought not to protect someone who will admit that there was a contract as part of the pleadings, testimony, or otherwise in court[2]).

Professor Townsend is also a great teacher, winning multiple awards for his pedagogical talents, and inspiring his students for decades to practice the Townsend theories. His ideas so influenced Indiana law that one time when I was in North Carolina for a year as a visiting professor, I was able to read an opinion of the Indiana Supreme Court and know to a certainty that the theory adopted by the court was Townsend's creation alone, long taught, now law. Like an ocean, he has so beat against the rocks of legal learning in this state that the whole shoreline has been shaped by his persistent onslaught. And the state is better for it, too, having some of the most advanced legal positions in the United States as a result of the Townsend influence.

Finally, R. Bruce Townsend will be remembered as a great human being. Whether as husband, father, colleague, illustrator, mentor, golfer, scholar, "art" collector, legal bully, advisor, or, simply, friend, he has impressed all who have dealt with him as warm, wise, generous, and, all in all, a man to remember. I treasure all my experiences with him and the stories I can tell about him (most of which I dare not relate here), and on the occasion of his alleged retirement, I am proud to say that I am his friend and that I wish him well.

DOUGLAS J. WHALEY
Professor of Law,
The Ohio State University
College of Law

[2]U.C.C. § 2-201(3)(b).

Indiana Law Review

Volume 15 | 1982 | Number 2

Secured Creditors Under the Bankruptcy Reform Act

FRANK R. KENNEDY*

I. INTRODUCTION

"[T]he theme of the Bankruptcy Act is equality of distribution."[1] Although Mr. Justice Douglas liked to stress that theme in his opinions for the Supreme Court construing the Bankruptcy Act,[2] there are many dissonances in bankruptcy. The rights of secured creditors in the estates of their debtors were extensively recognized in the Bankruptcy Act[3] and are still more fully particularized in the Bankruptcy Reform Act of 1978.[4] The reconciliation of the competing claims of secured and unsecured creditors has been a principal concern of the drafters of the bankruptcy laws and is the focus of the contributions to this symposium.

Security is a hedge against bankruptcy and other manifestations of the debtor's insolvency. To the extent a secured creditor obtains protection against the necessity of sharing in the losses suffered by other creditors of an insolvent debtor, he frustrates a fundamental bankruptcy objective. Notwithstanding all the virtues of equality, however, vindication of this objective of bankruptcy is not the only relevant consideration in a system of credit and credit administration. Extension of credit is, at least generally, a voluntary act on the part of the creditor. Borrowers and purchasers of property and services vary in their creditworthiness. The risk of nonpayment by some debtors is so serious that they are unable to obtain credit without giving security. Some lenders and vendors are generally unwilling to extend any credit without taking security. Even when a prospective debtor is creditworthy and the creditor is able and willing to extend unsecured credit, secured credit may be cheaper or more easily obtainable.

---

*Thomas M. Cooley Professor of Law, University of Michigan.

[1]Sampsell v. Imperial Paper & Color Corp., 313 U.S. 215, 219 (1941).

[2]*See also* Nathanson v. NLRB, 344 U.S. 25, 29 (1952).

[3]The Bankruptcy Act is the title given the Bankruptcy Act of 1898, as amended many times before and after 1950, by Pub. L. No. 879, 64 Stat. 1113 (1950). The Bankruptcy Act was repealed by Pub. L. No. 95-598, § 401(a), 92 Stat. 2682 (1978).

[4]Pub. L. No. 95-598, 92 Stat. 2549 (1978).

Accordingly, the bankruptcy laws of the United States (and of other countries as well)[5] recognize the necessary role of secured credit by permitting the enforcement, subject to limitations, of the rights of secured creditors. The bankrupcy laws of the United States have treated as a secured creditor only one who is secured by a lien against property.[6] A creditor who obtains in addition to his claim against the debtor the personal obligation of another is accorded certain rights appropriate to his position[7] but is not a secured creditor in the context of this discussion. A secured creditor under the bankruptcy laws holds an interest in or charge against property of the debtor whose estate is being administered,[8] but these laws have increasingly differentiated in their treatment of various kinds of secured claims by reference to the nature and origin of the lien of the creditor.[9]

II. Nonconsensual Liens

The original lien at common law is one that arises by operation of law in favor of an artisan or other bailee who renders a kind of service respecting personal property.[10] Not every bailee rendering service respecting personal property has been protected by a common-law lien, and a common-law lienor is accorded only the right to retain the property subject to the lien until the debt incurred for the service is paid. Common-law liens include those given a carrier, a warehouseman, a landlord, an innkeeper, and a seller.[11] With a minor qualification,[12] this variety of lien has always been enforceable under the bankruptcy laws.

Common-law liens have for the most part been superseded in

---

[5]European Bankruptcy Laws 58 (the law of Austria), 71 (the law of Belgium), 96-97 (France), 126-27 (Germany), 145 (Sweden) (I. Ross ed. 1974).

[6]See section 1(28) of the Bankruptcy Act, 11 U.S.C. § 1(28) (1976) (repealed 1978), and sections 101(28) & 605(a) of Title 11 of the United States Code as enacted in 1978. It is to be noted that the Bankruptcy Reform Act does not use the term "secured creditor." *See* note 66 *infra* and accompanying text.

[7]Thus he is protected against competition by the codebtor in the latter's pursuit of a right of reimbursement, subrogation, or contribution. *See* 11 U.S.C. § 509(c) (Supp. IV 1980). This subordination provision in the Bankruptcy Reform Act codifies the prior case law.

[8]11 U.S.C. §§ 101(28), (37) (Supp. IV 1980).

[9]*See* notes 61-65 *infra.*

[10]7 W. Holdsworth, A History of English Law 511 (1926).

[11]*Id.* at 511-13; 2 G. Gilmore, Security Interests in Personal Property § 33.2 (1965).

[12]Common-law liens of distraint for rent were subordinated and restricted by section 67c of the Bankruptcy Act. 4 W. Collier, Bankruptcy ¶ 67.28[1] (14th ed. W. Moore 1978). They are voidable by the trustee under the Bankruptcy Reform Act. 11 U.S.C. §§ 101 (38), 545(4) (Supp. IV 1980).

practice by legislation creating statutory liens that accord more effective and more complete protection to those creditors favored by the legislature. A statutory lien is typically enforceable by sale upon compliance with statutory and relevant constitutional procedures.[13] A statutory lien may also secure a creditor without reference to any bailment of goods and may cover real property. Thus statutory liens include mechanics' liens on real estate and liens for taxes on both real estate and personal property. While the bankruptcy laws originally did not differentiate in their treatment of common-law and statutory liens, the proliferation of statutory liens and a developing sensitivity to the resulting frustration of the policy of the bankruptcy laws led to the introduction of restrictions on the enforcement of statutory liens by the Chandler Act in 1938.[14] These restrictions have since been extended.[15]

A variety of lien palpably offensive to the bankruptcy policy of equal distribution is one obtained by an unsecured creditor through the prosecution of judicial proceedings against an insolvent debtor. Thus the bankruptcy laws have treated this kind of lien as a form of voidable preference if obtained against an insolvent debtor within a prescribed period before the inception of administration of a

---

[13]For example, the statutory requirements for enforcing a warehouseman's lien as found in U.C.C. § 7-210. Whether acts of enforcement of a statutory lien amount to state action, subjecting the statute to constitutional scrutiny, depends upon the degree of involvement of a state functionary or institution. Flagg Bros., Inc. v. Brooks, 436 U.S. 149 (1978) (no state action found where statute merely authorized procedure for self-help). For a discussion of the constitutional problems engendered by the enforcement of statutory liens, see Note, *Creditors' Remedies as State Action*, 89 YALE L.J. 538 (1980); Note, 23 VILL. L. REV. 419 (1978).

[14]Statutory liens on personalty unaccompanied by possession and liens of distress for rent were subordinated to the first two classes of unsecured claims entitled to priority, and liens for wages and rent were restricted. Chandler Act ch. 575, § 67c, 52 Stat. 840, 877 (1938); Kennedy, *Statutory Liens in Bankruptcy*, 39 MINN. L. REV. 697, 703-16 (1955).

[15]In 1952 most statutory liens on personalty unaccompanied by possession were invalidated as against the trustee. Kennedy, *supra* note 14, at 716-22. In 1966, statutory liens were invalidated as against the trustee if: (1) like a priority, they were operative only on insolvency or in the event of a general distribution of the debtor's property; (2) they were not effective against a bona fide purchaser from the debtor; or (3) they constituted liens of distress for rent. Moreover, tax liens on personalty unaccompanied by possession were postponed to the first two classes of priority claims. Bankruptcy Act §§ 29(a) and 67c as amended by 80 Stat. 268, 268-69 (1966). The Bankruptcy Reform Act of 1978 allows a pre-petition payment or transfer of his property by the debtor in discharge of a statutory lien to be attacked as a preference for the first time, and in liquidation cases a tax lien is subordinated to all the priority claims except those for taxes. 11 U.S.C. §§ 545, 547, 724(b); Schneyer, *Statutory Liens Under the New Bankruptcy Code—Some Problems Remain*, 55 AM. BANKR. L.J. 1 (1981).

debtor's estate.[16] Although a lien obtained by judicial proceedings is typically created and regulated by statute, the term "statutory lien" as used here and in the bankruptcy laws generally does not include a lien obtainable by an unsecured creditor in pursuing his judicial remedies for collection. Judicial liens include those obtained incident to judgment, execution, attachment, garnishment, creditor's bill, and proceedings supplementary to execution.

A lien obtained by an agreement between a debtor and his creditor is no less offensive to the bankruptcy policy of equal treatment of all creditors than is one obtained by the unilateral action of a creditor through judicial proceedings. Although the bankruptcy laws have generally been more considerate of the position of a consensual lienor than of a judicial lienor in the avoidance sections,[17] the differentiation has been diminishing and has nearly disappeared in the Bankruptcy Reform Act.[18] Consensual liens include real estate mortgages, security interests in personal property, and miscellaneous other types of encumbrances arising out of agreements to give security.[19]

The variety of lien known as an "equitable lien" has been characterized as neither equitable nor a lien because it confers an inequitable advantage over other unsecured creditors but does not prevail against a bona fide purchaser.[20] An equitable lien is a shorthand term for a species of relief given by a court of equity to a creditor.[21] Thus equity courts have typically awarded such a lien to a

---

[16]This kind of lien was voidable by the trustee without regard to the state of the creditor's mind under section 67 of the Bankruptcy Act, if obtained during insolvency and within four months of the filing of a petition by or against the debtor. J. MacLachlan, Handbook of the Law of Bankruptcy § 202 (1956).

[17]Thus, until enactment of the reform effected by section 547(b) of the Bankruptcy Code, reasonable cause to believe that the debtor was insolvent was required to be shown by the trustee seeking to avoid any consensual lien as a preference under the Bankruptcy Laws, whereas no such requirement was imposed when the trustee sought to avoid a judicial lien. *See id.*

[18]The differentiation of the treatment of judicial liens and consensual liens as preferential transfers is largely eliminated by section 547 of the Bankruptcy Code. *See* 4 Collier on Bankruptcy ¶ 547.12 (15th ed. L. King 1981) [hereinafter cited as Collier (15th ed.)].

[19]A consensual lien is a "security interest" under section 101(37). The term as used in the Bankruptcy Reform Act has a broader connotation than as used in the Uniform Commercial Code in that it extends to interests in real property. H.R. Rep. No. 595, 95th Cong., 1st Sess. 314 (1977), *reprinted in* [1978] U.S. Code Cong. & Ad. News 5963, 6271.

[20]*See* 1 G. Gilmore, Security Interests in Personal Property 200 (1965) ("Like the Holy Roman Empire, which was said to be neither holy nor Roman nor an empire, the equitable lien is neither equitable nor a lien").

[21]*See* Britton, *Equitable Liens—A Tentative Analysis of the Problem,* 8 N.C.L. Rev. 388 (1930); Glenn, *The "Equitable Pledge," Creditors' Rights, and the Chandler Act,* 25 Va. L. Rev. 422 (1939).

lender of funds for purchasing or improving real property when the loan is made in reliance on a promise to give security in the property.[22] Equitable liens against personal property have well nigh disappeared from cases administered under the bankruptcy laws since the general adoption of the Uniform Commercial Code,[23] and they do not appear frequently in cases involving real property.[24] The bankruptcy laws have been increasingly hostile to such a lien,[25] and the Bankruptcy Reform Act carries the attack further than previous legislation.[26]

A maritime lien, like a common-law or statutory lien, ordinarily arises by operation of law.[27] A maritime lien is nevertheless a distinctive category subject to different rules respecting its origin, nature, validity, and priority. The bankruptcy laws have been silent

---

[22]*See* 51 Am. Jur. 2d *Liens* §§ 33-34 (1970).

[23]Morris, *Bankruptcy Law Reform: Preferences, Secret Liens and Floating Liens*, 54 Minn. L. Rev. 737, 753 (1970); *but see* Warren Tool Co. v. Stephenson, 111 Mich. App. 274, 161 N.W.2d 133 (1968), *criticized in* Note, *Security Agreements, Equitable Liens, and the Uniform Commercial Code*, 69 Colum. L. Rev. 1280 (1969).

There is no reference to "equitable liens" in the index to J. White & R. Summers, Uniform Commercial Code (2d ed. 1980); *see also* 1 G. Gilmore, Security Interests in Personal Property 155, 199-200 (1965); 2 *id.* at 1302.

A notable exception to the demise of equitable liens against personal property is the equitable right of subrogation accorded a surety on a construction bond against a fund retained by the obligor of a construction contract. This right, often called an "equitable lien," has been allowed to prevail as against a trustee in bankruptcy of the contractor. Pearlman v. Reliance Ins. Co., 371 U.S. 132 (1962); Kennedy, *The Inchoate Lien in Bankruptcy: Some Reflections on* Rialto Publishing Co. v. Bass, 17 Stan. L. Rev. 793, 817-18 (1965).

[24]The index to the multivolume 15th edition of *Collier on Bankruptcy* contains no entry under the heading of "equitable lien" or any similar rubric. Similarly the successor to Professor Osborne's *Hornbook on Mortgages*, G. Osborne, G. Nelson, & D. Whitman, Real Estate Finance Law (1979), contains no index entries for "equitable liens" or "equitable mortgages." Compare, *e.g.*, G. Osborne, Handbook on the Law of Mortgates ch. 2 (2d ed. 1951), where equitable mortgages are discussed at length.

[25]*See* 1 G. Gilmore, Security Interests in Personal Property § 7.2 (1965); 2 *id.* §§ 45.3.3, 45.4.

[26]The trustee will prevail over most equitable liens in personal property as a hypothetical lien creditor under section 544(a)(3). The Bankruptcy Reform Act includes no insurance policy against the repetition by an obdurate court of such a decision as Porter v. Searle, 228 F.2d 748 (10th Cir. 1955) (repossession of stock of merchandise on the eve of bankruptcy by an equitable lienor sustained against attack by the trustee under section 60 of the Bankruptcy Act), *criticized in* 2 G. Gilmore, Security Interests in Personal Property § 45.7 (1965) *and* MacLachlan, *The Title and Rights of the Trustee in Bankruptcy*, 14 Rutgers L. Rev. 653, 676 (1960).

[27]*See* Landers, *The Shipowner Becomes a Bankrupt*, 39 U. Chi. L. Rev. 490, 510, 512 (1972). A recent appellate court decision treated a maritime lien in a bankruptcy case as a statutory lien. *In re* Mission Marine Assocs., Inc., 633 F.2d 678 (3d Cir. 1980). *See also* Landers, *supra*, at 512-14. Maritime liens nevertheless may sometimes apparently arise by agreement of the parties. *Id.* at 512.

in regard to maritime liens, and the case law governing the treatment of such liens in a bankruptcy context is not well developed. The express grant to bankruptcy courts by the Bankruptcy Reform Act of the powers of a court of admiralty[28] may lead to the formulation of more distinct rules and a clarification of this area of bankruptcy.

III. CONSENSUAL LIENS: THE LAW PRIOR TO 1978

As already intimated, the bankruptcy laws have become increasingly specific in dealing with the rights of secured creditors. The general tendency of this legislation has been to restrict those rights in the interest of facilitating attainment of the objectives of the bankruptcy laws to effect equality of distribution and to afford a fresh start for the debtor. The first two bankruptcy laws of the United States made only brief, oblique references to secured creditors or liens.[29] The Bankruptcy Act of 1867 contained the first explicit provision protecting valid security interests against the statutory representative of the unsecured creditors.[30]

The Bankruptcy Act of 1898 began a deliberate attack on certain liens by defining the word "transfer" to include a conditional parting with property as security,[31] invalidating preferential and fraudulent transfers,[32] and by including in a section entitled "Liens" provisions that enabled the trustee to avoid liens under prescribed conditions.[33] The trustee's hand was substantially strengthened in 1910 by the enactment of the strong-arm clause, which enabled the trustee to avoid any lien that could have been defeated under nonbankruptcy law by a judicial lien creditor on the date of the filing of a petition by or against the bankrupt.[34] This provision originally endowed the

---

[28]28 U.S.C. § 1481 (Supp. IV 1980).

[29]A principal concern of the drafters of the Bankruptcy Acts of 1800 and 1841 was that the bankrupt estate should be able to obtain the benefit of the debtor's right to redeem property subject to a secured creditor's lien. *See* Bankruptcy Act of 1800, ch. 19, § 12, 2 Stat. 19, 24-25 (repealed 1803); Bankruptcy Act of 1841, ch. 9, § 11, 5 Stat. 440, 447 (repealed 1843). The Act of 1800 also contained a provision that a creditor having a judicial or statutory security not yet enforced by a pre-petition levy of execution should not be allowed a preference in distribution over other creditors. Act of 1800, § 31, 2 Stat. at 30.

[30]Ch. 176, § 14, 14 Stat. 517, 523-24 (repealed 1878). This section also contained authority for the liquidator of the estate to redeem the bankrupt's property from the lien of a secured creditor or to sell the property subject to the lien. *See also id.* § 20, 14 Stat. at 526.

[31]Ch. 541, § 1(25), 30 Stat. 544, 545 (repealed 1978).

[32]*Id.* §§ 60, 67c, 30 Stat. at 562, 564.

[33]*Id.* § 67a (unperfected liens), 67c (liens of judicial proceedings), and 67f (liens of legal proceedings), 30 Stat. at 564, 565.

[34]Act of June 25, 1910, ch. 412, § 8, 36 Stat. 838, 840 (repealed 1978) (amending Bankruptcy Act of 1898, ch. 541, § 47a(2), 30 Stat. 544, 557).

trustee with the lien of a judicial proceeding only in respect to property in the custody of the bankruptcy court,[35] but in 1952 the hypothetical lien was given the trustee without regard to who had possession.[36] The strong-arm clause has proved to be a valuable weapon to the trustee defeating unperfected liens, particularly such liens on personal property.[37]

The crucible for subjecting security to the severest test is usually recognized to be the preference provisions of the bankruptcy laws. The effectiveness of the preference law in enabling the trustee to overcome a security interest has been significantly strengthened by a series of statutory changes beginning in 1938. Congress had made noteworthy efforts earlier to deal with the use of security interests to frustrate the preference policy of the bankruptcy laws. A series of amendments enacted prior to 1938 were intended to render vulnerable to avoidance security interests perfected within the four months before bankruptcy.[38] These efforts developed out of a recognition that secret liens offend bankruptcy policy. The doctrine of reputed ownership, which evolved from *Twyne's Case*,[39] rendered secret security interests void or voidable by unsecured creditors as a form of fraud. Peter Coogan has observed that the history of secured credit for the last two hundred years is largely a record of the efforts of unsecured creditors to force secured creditors to disclose their security and of the efforts of secured creditors to find ways of circumventing the legal strictures imposed on them at the instigation of unsecured creditors.[40] The strong-arm clause was enacted to enable the trustee in bankruptcy to invoke the doctrine of reputed ownership in the various forms in which it had been adopted by the states.[41] But the doctrine did not help the creditors or the trustee in most states if the secured creditor succeeded in taking possession or otherwise perfecting his interest before levy by any unsecured creditor or attachment of the trustee's hypothetical lien. To allow a secured creditor to prevail against the trustee notwithstanding belated perfection on the eve of bankruptcy ran counter to bankruptcy policy

---

[35]With respect to property not in the custody of the court, the trustee was given the rights, remedies, and powers of a judgment creditor with an execution returned unsatisfied. As a practical matter, these rights have been of little use to the trustee.

[36]Act of July 7, 1952, Pub. L. No. 456, § 23(b), 66 Stat. 420, 430 (repealed 1978).

[37]*See* 4B COLLIER ON BANKRUPTCY ¶¶ 70.55-.62A (14th ed. W. Moore 1978).

[38]Act of Feb. 5, 1903, ch. 487, § 13, 32 Stat. 797, 799-800; Act of June 25, 1910, ch. 412, § 11, 36 Stat. 838, 842; Act of May 27, 1926, ch. 406, 44 Stat. 662, 666.

[39]76 Eng. Rep. 809 (Star Chamber 1601).

[40]Coogan, *Public Notice Under the Uniform Commercial Code and Other Recent Chattel Security Laws, Including "Notice Filing,"* 47 IOWA L. REV. 289, 289 (1962).

[41]45 CONG. REC. 2277 (1910).

in two respects: the belatedly perfected security interest was indistinguishable in observable effects from a security interest created on the eve of bankruptcy to secure an antecedent debt; and the secrecy of the lien pending the perfection was potentially prejudicial to creditors who extended credit on the assumption that the secret lienor was not secured. The effort to deal with this problem finally succeeded in 1938 with the incorporation of a bona fide purchaser test in the preference section for the purpose of determining the time when a transfer to a creditor occurs.[42] That turned out to be overkill because security interests in inventory and certain other kinds of personalty are never perfected against some bona fide purchasers.[43] An amendment to the preference section introducing a lien creditor test with respect to personalty was added in 1950.[44]

Although a security interest for a contemporaneous consideration, if promptly perfected, has generally withstood attack by the trustee in bankruptcy, the Chandler Act attempted codification of the Supreme Court precedent of *Dean v. Davis*,[45] which invalidated a mortgage for a present loan because the purpose of the loan was to enable the debtor to make a preferential payment to a particularly insistent creditor.

The most dramatic development in the law of security in this country occurred during the following two decades. All but one American state adopted Article 9 of the Uniform Commercial Code.[46] The Code simplified the law of personal property security and significantly improved the position of secured creditors in competition with unsecured creditors. A result was an enormous expansion in the use of inventory and accounts receivable as collateral by business borrowers. At the same time the Code facilitated a vast expansion of consumer credit, both secured and unsecured. A troublesome problem generated by this development involved the status of a security interest created in collateral acquired on the eve of bankruptcy to secure an antecedent debt. The Uniform Commercial Code sanctioned

---

[42]Chandler Act, ch. 575, § 60, 52 Stat. 840, 869 (1938) (repealed 1978).

[43]*See* Corn Exchange Nat'l Bank & Trust Co. v. Klauder, 318 U.S. 434 (1943) (striking down an assignment of accounts receivable). *See also* 2 G. Gilmore, Security Interest in Personal Property 1302 (1965) ("In the entire history of statutory drafting, the 1938 revision of § 60 is the classical example of overkill").

[44]Act of March 18, 1950, ch. 70, § 60, 64 Stat. 24, 26 (1950) (repealed 1978).

[45]242 U.S. 438 (1917). There were two attempts at codification in section 67d(3) of the Bankruptcy Act. The original version enacted in 1938 was amended in 1952. Act of July 7, 1952, ch. 579, 66 Stat. 420, 428 (1952) (repealed 1978). The difficulties presented by this legislation are discussed in 4 Collier on Bankruptcy ¶ 67.38 (14th ed. W. Moore 1978).

[46]The lone state is Louisiana. The record of enactment of the Code is set out tabularly in 1 U.L.A. 1-2 (Supp. 1981).

such a security arrangement,[47] but it appeared to conflict with the preference policy of the Bankruptcy Act, especially when the collateral acquired on the eve of bankruptcy did not replace other collateral acquired earlier. Judicial resolution of this problem created the possibility of easy frustration of the preference policy by allowing any creditor to obtain protection from the trustee's use of the preference provisions of the Bankruptcy Act by filing a financing statement when the credit was extended.[48]

The treatment of valid secured claims was largely left to implication by the Bankruptcy Act. The enforceability of liens to the exclusion of priority and general unsecured claims was a matter of inference, and the relative priority of liens was governed by nonbankruptcy law except in the limited situation where a security interest was junior by nonbankruptcy law to a lien invalidated or postponed by the Bankruptcy Act.[49] Provision was made for determining the amount of a deficiency owing an undersecured creditor.[50] The right of the trustee to sell property of the estate free of liens was established by case law.[51]

The foregoing observations have been confined to the effect of the provisions of the Bankruptcy Act that applied in straight bankruptcy—that is, liquidation—rather than reorganization or rehabilitation under a plan. Beginning in 1933 Congress enacted reorganization legislation for railroads and corporations[52] that assured secured creditors of absolute priority of their interests in an enterprise reorganized under the legislation.[53] If the secured creditor did

---

[47]*See* U.C.C. §§ 9-108, -204(3) (1962 Official Text). *See* 2 G. GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY §§ 45.6-.7 (1965).

[48]*See, e.g.*, DuBay v. Williams, 417 F.2d 1277 (9th Cir. 1969); Grain Merchants of Indiana, Inc. v. Union Bank & Sav. Co., 408 F.2d 209 (7th Cir.), *cert. denied*, 396 U.S. 827 (1969); Rosenberg v. Rudnick, 262 F. Supp. 635 (D. Mass. 1967).

[49]The Bankruptcy Act generally dealt with such situations, creating a potential windfall for the junior lienor or generating circuity of priority, by preserving the impaired lien for the benefit of the estate. *See* Kennedy, *The Trustee in Bankruptcy as a Secured Creditor Under the Uniform Commercial Code*, 65 MICH. L. REV. 1419, 1434-39 (1967).

[50]Bankruptcy Act of 1898, ch. 541, § 57h, 30 Stat. 544, 560, *superseded by* BANKR. R. 306(d).

[51]The leading case is Van Huffel v. Harkelrode, 284 U.S. 225 (1931).

[52]The first reorganization statute was section 77, the railroad reorganization law. Act of March 3, 1933, ch. 204, §§ 77, 47 Stat. 1467, 1474. This statute was followed by section 77B, the first general corporate reorganization law. Act of June 7, 1934 ch. 424, § 77B, 48 Stat. 911, 912. Section 77 was not amended by the Chandler Act, but section 77B was superseded by Chapters X and XI of that Act.

[53]This guaranty was embodied in the "fair and equitable" standard imposed as a requirement for confirmation of a reorganization plan. Act of March 3, 1933, ch. 204, § 77(e)(1), 47 Stat. 1467, 1478; Chandler Act, ch. 575, § 221(2), 52 Stat. 840, 897 (1938);

not consent to the provision made for it in the plan, it was protected by a statutory guaranty of receipt of the full value of its claim against the debtor's property.[54] Relief afforded political subdivisions by legislation enacted in the mid-1930's also protected the absolute priority of secured creditors.[55]

Rehabilitation legislation enacted by the Chandler Act of 1938 also dealt with security interests in realty owned by a debtor other than a corporation[56] and with security interests in personalty owned by a wage earner.[57] The secured creditor of a wage earner was protected against any modification of his lien against personalty without his consent in a Chapter XIII case,[58] but the creditor of a noncorporate debtor secured by realty might be subjected to cramdown by the court's confirmation of a plan under Chapter XII that provided the creditor with the appraised value of his interest in the realty.[59] The bankruptcy court was empowered in any rehabilitation case to enjoin enforcement of a lien during the pendency of the case.[60]

IV. Consensual Liens Under the Bankruptcy Reform Act

The Bankruptcy Reform Act is more explicit in regard to the

Consolidated Rock Prods. Co. v. Du Bois, 312 U.S. 510 (1941) (construing the "fair and equitable" requirement of § 231(1)); Case v. Los Angeles Lumber Prods. Co., 308 U.S. 106 (1939) (similarly construing the same requirement of § 77B(f)(1)).

[54]When a secured creditor or class of secured creditors did not accept the provisions of a plan in a Chapter X case affecting its rights, adequate protection of the value of their claims was required to be provided by § 216(7) governing "cramdown." *See, e.g.*, Wachovia Bank & Trust Co. v. Harris, 455 F.2d 841 (4th Cir. 1972). A comparable provision enabled the court to confirm a plan under section 77 cashing out secured creditors without their acceptance if the payment covered the value of their interests. Act of March 3, 1933, ch. 204, § 77(e), 47 Stat. 1467, 1478.

The "fair and equitable" requirement and the cramdown provision did not apply in Chapter XI cases, but secured creditors' rights could not be affected by a Chapter XI plan. *But see* R.I.D.C. Indus. Dev. Fund v. Snyder, 539 F.2d 487 (5th Cir. 1976), *cert. denied*, 429 U.S. 1095 (1977) (sustaining provisions of a confirmed Chapter XI plan altering a secured creditor's rights with its consent).

[55]Act of August 16, 1937, ch. 657, § 83(e), 50 Stat. 653, 658.

[56]Chandler Act, ch. 575, §§ 606(1), 646(2), 52 Stat. 840, 930, 934.

[57]*Id.* § 652(1), 52 Stat. at 934.

[58]*Id.* § 461(11), 52 Stat. at 922.

[59]*Id.* § 468(1), 52 Stat. at 923.

[60]11 U.S.C. §§ 205(j), 402(c), 516(4), 714, 814, 1014 (1976) (repealed 1978) (Bankruptcy Act §§ 77(j), 83(c), 116(4), 314, 414, 614); *see also id.* § 11(a)(15) (Bankruptcy Act § 2a(15)). Automatic stays were provided by *id.* § 548 (Bankruptcy Act § 148) in a Chapter X case and *id.* § 828 (Bankruptcy Act § 428) and possibly *id.* § 907 (Bankruptcy Act § 507) in a Chapter XII case. These statutory provisions were supplemented by automatic stays provided by Bankruptcy Rules 8-501, 9-4, 10-601, 11-44, 12-43, and 13-401. *See* Kennedy, *The Automatic Stay in Bankruptcy*, 11 U. Mich. J.L. Ref. 177, 177 n.1 (1978).

rights of secured creditors than any previous bankruptcy legislation. Numerous rights of secured creditors and limitations on those rights declared in the new law were in doubt under prior law. A number of limitations are new, and in a few respects secured creditors are given rights never before recognized in bankruptcy legislation.

A. Valid Liens

The Bankruptcy Reform Act not only defines "statutory lien"[61] as did the Bankruptcy Act[62] but also defines "lien,"[63] "judicial lien,"[64] and "security interest."[65] Although setoff is not made a lien by definition, the new law treats it as one.[66] A section entitled "Determination of secured status" is crucial to the secured creditor's rights: it spells out the fact that an undersecured creditor has two claims—a secured claim limited by the value of the interest constituting the security and an unsecured claim in the amount of the deficiency;[67] it negates an argument that a valuation of the security for one purpose is thereafter conclusive for other purposes;[68] it specifies the right of a creditor to post-petition interest when his claim is covered by sufficient collateral, and to attorneys' fees, even though the latter may not be collectible under nonbankruptcy law;[69] and it subjects the security interest to the expenses of preservation and enforcement.[70] An innovative proposal that a secured claim must be proved in order to be allowed did not survive,[71] but it is provided

---

[61]11 U.S.C. § 101(38) (Supp. IV 1980) provides:

> "statutory lien" means lien arising solely by force of a statute on specified circumstances or conditions, or lien of distress for rent, whether or not statutory, but does not include security interest or judicial lien, whether or not such interest or lien is provided by or is dependent on a statute and whether or not such interest or lien is made fully effective by statute . . . .

[62]11 U.S.C. § 1(29a) (1976) (repealed 1978). The two definitions are practically identical except for the inclusion in the 1978 act of a "lien of distress for rent, whether or not statutory" and the clarifying exclusion of a "security interest or judicial lien."

[63]*Id.* § 101(28) provides: " 'lien' means charge against or interest in property to secure payment of a debt or performance of an obligation."

[64]*Id.* § 101(27) provides: " 'judicial lien' means lien obtained by judgment, levy, sequestration, or other legal or equitable process or proceeding."

[65]*Id.* § 101(37) provides: " 'security interest' means lien created by an agreement."

[66]*See, e.g., id.* §506(a) which provides: "An allowed claim of a creditor . . . that is subject to setoff under section 553 of this title is a secured claim . . . to the extent of the amount subject to setoff . . . ." *See also* 124 Cong. Rec. 32,398 (1978) (Congressman Edwards' statement); *id.* at 33,997 (1978) (Senator DeConcini's statement).

[67]11 U.S.C. § 506(a) (Supp. IV 1980).

[68]*Id.*

[69]*Id.* § 506(b); 124 Cong. Rec. 32,398 (1978) (Congressman Edwards' statement); *id.* at 33,997 (1978) (Senator DeConcini's statement).

[70]11 U.S.C. § 506(c).

[71]H.R. 6, 95th Cong., 1st Sess. § 506(d) (1977).

that if a challenge or a request directed at a security interest is filed, proof is required to save it from invalidity.[72]

The Bankruptcy Reform Act imposes an automatic stay of most litigation, proceedings, and acts against the debtor and his property from the moment a petition is filed by or against the debtor.[73] The impact of this stay falls most heavily on secured creditors, who are thereby prevented from enforcing their rights in their security unless and until they obtain relief. The statutory provisions for the stay are, however, largely a continuation of prior law. Although limited automatic stays were provided for in only two of the rehabilitation chapters enacted in 1938,[74] Rules of Bankruptcy Procedure promulgated in 1973-1976 covered much of the same ground as the statutory stay.[75] A significant difference in the statutory stay is the explicit requirement for relief from the stay on request if the complainant is not provided adequate protection of his interest or the debtor lacks equity in property not necessary for reorganization.[76]

A significant new section explicitly authorizes and regulates the use of collateral by a debtor during the pendency of a case.[77] The legislation codifies and extends the fragmentary case law respecting such use that developed under the Bankruptcy Act.[78] The same section spells out the bankruptcy court's authority to sell property free of a lien.[79]

The Bankruptcy Reform Act recognizes more fully than did the Bankruptcy Act the power of the bankruptcy court to subordinate

---

[72]11 U.S.C. § 506(d)(1).

[73]*Id.* § 362. *See* Kennedy, *Automatic Stays Under the New Bankruptcy Law*, 12 U. MICH. J.L. REF. 1 (1978).

[74]Chandler Act, ch. 575, §§ 148, 428, 52 Stat. 840, 888, 918 (1930); *see also id.* § 507, 52 Stat. 927.

[75]*See* note 60 *supra.*

[76]11 U.S.C. § 362(d)-(f).

[77]*Id.* § 363(a)-(c).

[78]*See* Webster, *Collateral Control Decisions in Chapter Cases—Clear Rules v. Judicial Discretion*, 51 AM. BANKR. L.J. 197 (1977); Murphy, *Use of Collateral in Business Rehabilitations: A Suggested Redrafting of Section 7-203 of the Bankruptcy Reform Act*, 63 CALIF. L. REV. 1483 (1975).

[79]11 U.S.C. § 363(f). As pointed out at note 51, *supra*, the court's authority had been established by judge-made law, and section 363(f) may be viewed as a codification and clarification of the law applicable to such sales. Compare section 5-203(b) of the Bankruptcy Act of 1973 and the accompanying Note 2, H.R. DOC. NO. 137, Part II, 93d Cong., 1st Sess. 191-92 (1973) (trustee may sell property free of liens without a hearing unless a dispute arises). Bankruptcy Rule 606(b)(3), not being inconsistent with the statutory provision, may appropriately govern the procedure in such a sale. *See* Kennedy, *An Adversary Proceeding Under the New Bankruptcy Rules, with Special Reference to a Sale Free of Liens*, 79 COM. L.J. 425 (1974). But compare proposed Bankruptcy Rule 6004(d), which was circulated to the bench and bar on March 1, 1982 for comment and which would eliminate any requirement for an adversary proceeding to obtain authority to sell property free of liens.

valid liens. Section 364, which authorizes the trustee or debtor in possession to obtain post-petition credit, explicitly accords to the court the power to grant a security interest to the post-petition creditor that is senior or equal to pre-petition liens. This power is subject to a showing at a hearing on notice that the credit is not otherwise obtainable and that the holder of any existing lien that is subordinated to or required to share equal priority with the newly granted security interest is afforded adequate protection.[80]

Section 510, which authorizes the court to subordinate one claim to another claim,[81] contemplates the possibility of subordination of a secured claim as well as an unsecured claim. The legislative intent in this respect is evident from the provision in subsection (c) of that section for the transfer of any subordinated lien to the estate.

B. *Avoidance of Liens*

The new bankruptcy law enlarges the trustee's powers of avoidance at the expense of secured creditors. Thus the trustee's strong arm as a hypothetical lien creditor has been extended by endowing him with the status of a hypothetical bona fide purchaser of realty as against any creditor who failed to take available steps to perfect his lien against such a purchaser.[82] The same section negates the mischievous doctrine of some Bankruptcy Act cases that purported

---

[80]Such authority was explicitly granted only in cases under sections 77 and 77B and Chapter X under prior law. 11 U.S.C. §§ 205(c)(3), 516(2) (1976) (repealed 1978). Section 344 authorized the issuance by a debtor in possession or receiver of certificates of indebtedness in a Chapter XI case, but no reference was made to the relative priority of such certificates. *Id.* § 744. *See generally* Banker, *Certificates of Indebtedness in Reorganization Proceedings: Analysis and Legislative Proposals*, 50 AM. BANKR. L.J. 1 (1976).

[81]11 U.S.C. §§ 510(a)-(c) (Supp. IV 1980). The subordination may simply enforce an agreement executed prior to the filing of the petition (§ 510(a)) or apply equitable principles recognized under prior law (§ 510(c)).

[82]*Id.* § 544(a)(3). Of course, the trustee may also prevail under this paragraph against an absolute transferee of the debtor's realty who had failed to perfect his interest by recordation or the taking of possession, but the most likely victim of the new weapon of the trustee is a mortgagee.

A new section declares a pre-petition security agreement purporting to cover property acquired by a debtor after the filing of the petition to be ineffective except as to proceeds, products, offspring, rents, or profits of property subject to a valid pre-petition security interest. 11 U.S.C. § 552. The invalidation of the after-acquired property clause follows what scant case authority there was under the Bankruptcy Act. *See In re* Sequential Information Systems, [1969-1973 Transfer Binder] SECURED TRANSACTIONS GUIDE (CCH) ¶ 51,749 (Bankr. S.D.N.Y. Dec. 15, 1970). An unsettling exception for the creditor having such a security interest allows the bankruptcy court, after notice and a hearing, to modify the creditor's lien in proceeds, products, offspring, rents, or profits "based on the equities of the case." 11 U.S.C. § 552(b).

to authorize a trustee to be subrogated to the position of any lienor, irrespective of the validity of his lien or of the amount of his lien, to defeat any junior lien.[83]

The most significant changes in the avoidance sections, so far as a secured creditor is concerned, are found in section 547, the new preference section. The period of vulnerability of a preferential transfer is reduced to ninety days unless the preferred creditor is an insider;[84] a preference to an insider remains voidable for a year. The cutback on the reach of the trustee's avoiding power when no insider is involved is countered by an elimination of the requirement that the creditor have had reasonable cause to believe that the debtor was insolvent at the time of the transfer and by the creation of a presumption that the debtor was then insolvent.[85] These aids are available, however, only when the trustee is attacking a preferential transfer made within the ninety-day period preceding bankruptcy. A transfer cannot occur for the purposes of the preference section before the debtor had an interest in the collateral;[86] therefore, the potential for a creditor to insulate his after-acquired collateral from attack by filing a financing statement before its acquisition is significantly diminished.[87] On the other hand, the floating lien of a lender secured by inventory or accounts receivable is afforded protection when the lienor is fully secured at the beginning of the period of vulnerability of a preference or when the lienor did not improve his position during the period.[88]

The section dealing with setoff likewise contains a new provision enabling the trustee to avoid a pre-petition setoff to the extent the

---

[83]11 U.S.C. § 544(b). The doctrine nullified by the revised subsection was criticized by Kennedy, *The Trustee in Bankruptcy as a Secured Creditor Under the Uniform Commercial Code*, 65 MICH. L. REV. 1419 (1967), and supported by Countryman, *The Use of State Law in Bankruptcy Cases* (Part II), 47 N.Y.U. L. REV. 631, 657-61 (1972).

[84]11 U.S.C. § 547(b)(4). An "insider" is defined in § 101(25) to include 18 categories of persons.

[85]*See id.* § 547(f). The presumption of insolvency is intended to be rebuttable. H.R REP. NO. 595, *supra* note 19, at 375, [1978] U.S. CODE CONG. & AD. NEWS at 6331; S. REP. NO. 989, 95th Cong., 2d Sess. 89 (1978), *reprinted in* [1978] U.S. CODE CONG. & AD. NEWS 5787, 5875.

[86]11 U.S.C. § 547(e)(3).

[87]The Code, therefore, overrules the cases cited *supra* note 48.

[88]11 U.S.C. § 547(c)(5). This paragraph, embodying a recommendation of a committee of the National Bankruptcy Conference, was a reconciliation of the view favoring full recognition in bankruptcy of a floating lien on after-acquired collateral and the position that all security interests arising in collateral proceedings acquired by a debtor during the four-month period preceding bankruptcy should be avoided as preferential. *See* H.R. REP. NO. 595, *supra* note 19, at 179, 204-19, [1978] U.S. CODE CONG. & AD. NEWS at 6164-79. For a captious view of section 547(c)(5), see Eisenberg, *Bankruptcy Law in Perspective*, 28 U.C.L.A. L. REV. 953, 959-71 (1981).

creditor was able thereby to improve the position he held vis-à-vis the debtor ninety days before the filing of the petition.[89] The same section retains the features of the law of setoff under the Bankruptcy Act, including the disallowance of setoff of a claim acquired during the debtor's insolvency on the eve of or after the filing of the petition.[90] Similar treatment is provided for a debt incurred by a creditor during the debtor's insolvency and the ninety-day period before the filing of the petition for the purpose of effecting a setoff.[91]

The effort to codify the doctrine of *Dean v. Davis*,[92] which invalidated a security interest given for the purpose of enabling the debtor to prefer other creditors, was terminated by omission of any provision in the new law purporting to deal with this situation. The attempted solution in the Bankruptcy Act had caused too many problems for debtors and potential lenders and purchasers dealing with debtors in good faith to warrant its retention.[93]

The Bankruptcy Reform Act extends the right of a debtor to avoid liens against exempt property far beyond anything found in prior bankruptcy law. The Chandler Act had codified a Supreme Court ruling that allowed a debtor to avoid a judicial lien obtained against exempt property during the debtor's insolvency and within four months of his bankruptcy.[94] The new law enables the debtor to avoid any judicial lien that impairs his exemption, without regard to when it was obtained or the solvency of the debtor at the time of its attachment.[95] Moreover, the debtor is authorized to avoid any nonpossessory non-purchase-money security interest impairing his exemption in tangible personal property of practically any kind except an automobile.[96] The premise of this provision is that because of the

---

[89]11 U.S.C. § 553(b). The application of this test only to pre-petition setoffs is intended to deter them in the interest of enhancing the chances that debtors in distress may survive financial crises as a result of the exercise of restraint by their bank creditors.

[90]*Id.* § 553(a)(2). This provision is derived from section 68b(2) of the Bankruptcy Act. *See* Bankruptcy Act of 1898, ch. 541, § 68b(2), 30 Stat. 544, 565.

[91]11 U.S.C. § 553(a)(3). This provision codifies a limitation on setoff recognized by prior case law. *See, e.g.*, Cusick v. Second Nat. Bank, 115 F.2d 150 (D.C. Cir. 1940); *cf.* Katz v. First Nat'l Bank, 568 F.2d 964 (2d Cir. 1977).

[92]*See* note 45 *supra*.

[93]H.R. Doc. No. 137, Part II, 93d Cong., 1st Sess. 177 (1973).

[94]Chandler Act ch. 575, § 67a(4), 52 Stat. 840, 876 (1938) (repealed 1978) (codifying Chicago, Burlington & Quincy Ry. v. Hall, 229 U.S. 511 (1913)). *See* 4 Collier on Bankruptcy ¶ 67.15[2] (14th ed. W. Moore 1978).

[95]11 U.S.C. § 522(f)(1).

[96]*Id.* § 522(f)(2). The constitutionality of this provision and that cited in the preceding footnote has been widely attacked with diverse results. The attacks have been predicated primarily on the fifth amendment and do not raise any serious question as to the prospective constitutionality of an application to liens that arose after the effective date of the Bankruptcy Reform Act. *Compare* Note, *Constitutionality of*

minimal value of the collateral for the purposes of a forced sale, such a lien does not serve the purpose of enabling the creditor to realize his claim by foreclosing his security interest. Because of the debtor's need for the property and its high replacement cost, however, the creditor's right to seize and sell the property invests him with coercive debt-collecting power that is incompatible with the fresh-start policy of the Bankruptcy Act. That, at any rate, is the rationale for giving the debtor for the first time the right under the bankruptcy laws to avoid a security interest for his own benefit. Section 522, the exemption section, also recognizes that the debtor may avoid any lien against exempt property for his own benefit that was not created by a voluntary transfer and was not avoided by the trustee.[97] Even if the trustee avoids a lien, the debtor may claim an exemption in property recovered by the trustee if the property had not been voluntarily transferred or concealed by the debtor.[98]

C. *Liens in Rehabilitation Cases*

The Bankruptcy Reform Act consolidates provisions that deal with rehabilitation as distinguished from liquidation. Reorganization of corporations, partnerships, and individually owned enterprises may be effected under Chapter 11,[99] and secured claims as well as unsecured claims may be dealt with in a plan proposed and confirmed under that chapter.[100] An official creditors' committee appointed in a Chapter 11 case, like an official creditors' committee elected under Chapter XI of the Bankruptcy Act,[101] can represent only the unsecured creditors,[102] but there is authority for the appointment of additional committees, including one or more commit-

---

Retroactive Lien Avoidance Under the Bankruptcy Code Section 522(f), 91 HARV. L. REV. 1616 (1981) (arguing against constitutionality) *with* Note, *Lien Avoidance Under Section 522(f) of the Bankruptcy Code: Is Retrospective Application Constitutional?*, 49 FORDHAM L. REV. 615 (1981) (upholding constitutionality) *and* 27 WAYNE L. REV. 1281 (1981) (upholding constitutionality).

[97] 11 U.S.C. § 522(h).

[98] *Id.* § 522(g).

[99] Chapter 11 is a consolidation of Chapters VIII, X, XI, and XII of the Bankruptcy Act. H.R. REP. NO. 595, *supra* note 19, at 220-24, 242-54, [1978] U.S. CODE CONG. & AD. NEWS at 6179-84, 6201-13.

[100] 11 U.S.C. § 1123(b)(1). A plan may also deal with any class of equity interests.

[101] 11 U.S.C. § 738 (1976) (Bankruptcy Act § 338) (repealed 1978); Bankr. R. 11-27, *id.* app.; While Chapter X of the Bankruptcy Act provided for creditors' committees, there was no official creditors' committee in a Chapter X case. *See id.* §§ 609-613 (Bankruptcy Act §§ 209-213); Bankr. R. 10-211, *id.* app.

[102] 11 U.S.C. §§ 1102(a)(1), 151102(a) (Supp. IV 1980). A creditors' committee may be elected in a Chapter 7 case pursuant to section 705(a), and as in a Chapter 11 case the committee members must be holders of unsecured claims.

tees for secured creditors.[103] A plan of reorganization under Chapter 11 may modify any secured debt with the consent of the creditor or of prescribed majorities of secured creditors in the same class.[104] If the plan leaves the secured creditor or a class of secured creditors unimpaired, acceptance is presumed without the necessity of any solicitation.[105] If the provisions of a plan affecting a secured debt are neither accepted nor deemed accepted, the court may nevertheless confirm a plan if it is found by the court to be "fair and equitable" and does not "discriminate unfairly."[106] The standard of "fair and equitable" is satisfied with respect to secured claims if the plan provides as follows:

> (i) (I) that the holders of such claims retain the lien securing such claims, whether the property subject to such lien is retained by the debtor or transferred to another entity, to the extent of the allowed amount of such claims; and
> (II) that each holder of a claim of such class receive on account of such claim deferred cash payments totalling at least the allowed amount of such claim, of a value, as of the effective date of the plan, of at least the value of such holder's interest in the estate's interest in such property;
> (ii) for the sale, subject to section 363(k) of this title, of any property that is subject to the lien securing such claims, free and clear of such lien, with such lien to attach to the proceeds of such sale, and the treatment of such lien on proceeds under clause (i) or (iii) of this subparagraph; or
> (iii) for the realization by such holders of the indubitable equivalent of such claims.[107]

---

[103]*Id.* §§ 1102(a)(2), 151102(b).

[104]*Id.* §§ 1122, 1126(a)-(c), 1129(a). Because all claims in a particular class must be substantially similar to each other (§ 1124(a)), each holder of a secured claim is ordinarily in a separate class. A single class of multiple holders of secured claims may be appropriate when they are (1) lienholders secured under a common indenture or mortgage, (2) banks participating in large loans secured by common collateral, or (3) holders of mechanics' liens having equal priority in respect to common property. D. EPSTEIN & M. SHEINFELD, BUSINESS REORGANIZATION UNDER THE BANKRUPTCY CODE: TEACHING MATERIALS 172 (1979).

[105]11 U.S.C. § 1126(f). A claim is unimpaired if the plan (1) leaves the creditor's rights unaltered; (2) cures any pre-petition default that entitled the creditor to accelerate the maturity of the debt and reinstates the original maturity date; or (3) provides for cash payment of the allowed amount of the claim on the effective date of the plan. *Id.* § 1124.

[106]*Id.* § 1129(b).

[107]*Id.* § 1129(b)(2)(A). This provision is derived from the cramdown provisions of Chapters X and XII of the Bankruptcy Act. *See* notes 54 & 59 *supra.* The reference in subparagraph(A)(iii) to the "indubitable equivalent" was derived from *In re* Murel

At a late stage in the legislative process Congress was persuaded to provide specialized relief for the holders of secured claims against property without recourse against their debtors for personal liability beyond that afforded by their collateral. The concern arose particularly out of the confirmation of plans under Chapter XII of the Bankruptcy Act which allowed the retention by partnerhip debtors of the property securing nonrecourse indebtedness on payment to the creditors of the appraised value of the property.[108] Relief was provided in section 1111(b) by giving a nonrecourse creditor in a Chapter 11 case an allowable claim as if he had recourse, but the relief was unavailable if the property was disposed of at a sale where the nonrecourse creditor could bid.[109] Both recourse and nonrecourse creditors are given an option under section 1111(b)(2) to waive their unsecured claims and to become secured creditors in the full amount of their claims without regard to the value of their collateral.[110] Creditors exercising that option are permitted to retain their liens until the full amount of their claims has been paid, but the present value of the payments need not exceed the value of their collateral.[111] The option is intended to enable secured creditors to realize the benefit accruing from a post-confirmation appreciation of value of their collateral.

Holding Corp., 75 F.2d 941 (2d Cir. 1935) (involving cramdown under former section 77B). 124 CONG. REC. 32,407 (1978) (statement of Congressman Edwards); *id.* at 34,007 (statement of Senator DeConcini).

[108]*See* COLLIER (15th ed.), *supra* note 18, ¶ 1111.02[1].

[109]11 U.S.C. § 1111(b)(1)(A)(ii). The recourse creditor retains his right of recourse whether or not the property is sold, provided he does not opt for the section 1111(b)(2) election discussed in the next sentence in the text.

[110]*Id.* § 1111(b)(2). This option is not available, however, if the interest of the creditor in collateral of the debtor is of inconsequential value. *Id.* § 1111(b)(1)(B)(i). Moreover, a recourse creditor may not choose the § 1111(b)(2) option if the property is sold. It is not clear why sale should deprive only the recourse creditor of the option. Under section 1111(b)(1)(A)(ii) the sale, however, had the effect of eliminating the status of the nonrecourse creditor as a recourse creditor. Arguably, therefore, the nonrecourse creditor is likewise barred from the section 1111(b)(2) election by the sale. *See* Pachulski, *The Cram Down and Valuation Under Chapter 11 of the Bankruptcy Code*, 58 N.C.L. REV. 925, 948 n.100 (1980).

By virtue of their waiver of unsecured deficiency claims, creditors who choose the section 1111(b)(2) option are not entitled to application of the "best interest of creditors" test of section 1129(a)(7)(A)(ii). This provision assures to each creditor a distribution at least equal to what he would receive on liquidation under Chapter 7. His acceptance of a position as a secured creditor without regard to the value of the collateral disentitles him to any expectation of any distribution as an unsecured creditor. 124 CONG. REC. 32,408 (1978) (Congressman Edwards' statement); *id.* at 34,007-08 (Senator DeConcini's statement).

[111]124 CONG. REC. 32,407 (1978) (Congressman Edwards' statement); *id.* at 34,007 (Senator DeConcini's statement).

Chapter 11 retains special legislation protective of the interests of financiers of certain transportation equipment.[112] The legislation is intended to permit the possession of such equipment to be taken by the holder of a purchase-money security interest in such equipment within a prescribed period after default, and neither the automatic stay nor the injunctive power of the bankruptcy court can save the equipment from the reach of the creditor.[113]

Chapter 13 of the Bankruptcy Reform Act is the successor to Chapter XIII of the Bankruptcy Act, but it contains significant reforms that affect secured creditors. While Chapter XIII afforded relief only to wage earners and similarly employed or compensated debtors,[114] Chapter 13 is available to any individual with regular income, including a self-employed debtor engaged in business.[115] There are limitations on eligibility with respect to the size of the debtor's secured and unsecured indebtedness,[116] but the effect is to substantially increase the number of persons eligible for relief under this chapter.

Another significant extension of the scope of the chapter is its authorization for the adjustment of both secured and unsecured debt without the consent of the creditors.[117] A plan may not reduce or extend a claim secured only by the debtor's residential real estate,[118]

---

[112]11 U.S.C. §§ 1110, 1168. Section 1110 relates to "aircraft, aircraft engines, propellers, appliances, or spare parts" and "vessels of the United States." Section 1168 relates to "rolling stock equipment or accessories used on such equipment, including superstructures and racks" and applies only in railroad reorganizations under Chapter 11.

[113]The rationale for these exceptions is set out in H.R. Rep. No. 595, *supra* note 19, at 238-41, 405, 423, [1978] U.S. Code Cong. & Ad. News at 6197-201, 6361, 6379; S. Rep. No. 989, *supra* note 85, at 117, 136, [1978] U.S. Code Cong. & Ad. News at 5903, 5922; 124 Cong. Rec. 32,396-97 (1978) (statement of Congressman Edwards); *id.* at 34,005 (statement of Senator DeConcini). As therein explained, the new legislation is intended to qualify the absolute right of a financier of transportation equipment conferred by provisions of the Bankruptcy Act to seize such equipment upon default. That the legislation fails to conform to the legislative design, see Kennedy, *Automatic Stays Under the New Bankruptcy Law*, 12 U. Mich. J.L. Ref. 1, 35-37 (1978).

[114]11 U.S.C. § 1006(8) (1976) (repealed 1978) (Bankruptcy Act § 606(8)) ("whose principal income is derived from wages, salary or commissions").

[115]11 U.S.C. § 101(24) (Supp. IV 1980) ("whose income is sufficiently stable and regular to enable such individual to make payments under a plan under chapter 13 of this title, other than a stock broker or a commodity broker"); *id.* § 109(e).

[116]*Id.* § 109(e). The petitioning debtor must have "noncontingent, liquidated, unsecured debts of less than $100,000 and noncontingent, liquidated secured debts of less than $350,000" in order to be eligible. A joint petition may nevertheless be filed by an individual and his or her spouse, even though only one of them has regular income, but their aggregate indebtedness must meet the limitations mentioned in the first sentence.

[117]*Id.* §§ 1322, 1325.

[118]*Id.* § 1322(b)(2).

but if the debtor is in default in respect to such a debt, his plan may provide for the curing of the default within a reasonable time during the pendency of the case.[119] In the meantime, regular payments must be made on the secured debt. A plan may not provide for payments over a period exceeding three years, unless the court approves a longer period of up to five years.[120] The discharge obtainable under a Chapter 13 plan does not extend to debts on which the last payment is due after the final payment under the plan.

A Chapter 13 plan may be confirmed by the court without the consent of any creditor.[121] Secured creditors are protected by section 1325(a)(5), which entitles the holder of each secured claim that can be modified, to one of the following modes of treatment: (1) a provision that is accepted by the creditor; (2) retention of the creditor's lien and distribution of property of a present value as of the effective date of the plan not less than the allowed amount of the creditor's secured claim; or (3) surrender of the property securing the claim. The second alternative is the one most frequently chosen, and considerable litigation has been engendered respecting the proper mode of determining the present value of the claim.[122]

A Chapter 13 plan must provide each unsecured creditor at least as much as would have been paid on liquidation under Chapter 7,[123] but because many petitioning debtors have no nonexempt assets of any significant value, many plans have been proposed for confirma-

---

[119]*Id.* § 1322(b)(5). Considerable litigation and diversity of judicial views have developed in respect to what constitutes a reasonable time under section 1322(b)(5). *Compare* Coleman v. Brown (*In re* Coleman), 5 Bankr. 812 (W.D. Ky. 1980) (3 years not reasonable) *with In re* Lynch, 12 Bankr. 533 (W.D. Wis. 1981) (3 years held reasonable).

There has also developed a diversity of opinion as to whether, after acceleration of the maturity of mortgage indebtedness by a creditor on account of a pre-petition default, the option to cure the default remains available under section 1322(b)(5). *Compare In re* Williams, 11 Bankr. 504 (S.D. Tex. 1981) (default held not curable after the creditor had elected to accelerate maturity because of the default) *with* Di Pierro v. Cullen (*In re* Toddeo), 9 Bankr. 299 (E.D.N.Y. 1981) (default allowed to be cured where Chapter 13 petition filed before entry of final judgment of foreclosure by state court; state law respecting effect of creditor's acceleration held not to be binding on the court in construing section 1322(b)(5)). *See generally* Beck, *The Plight of the Defaulting Mortgagor*, 15 IND. L. REV. 561 (1982).

[120]11 U.S.C. § 1322(c) (Supp. IV 1980).

[121]*Id.* § 1325(a), requiring the court to confirm a Chapter 13 plan if it meets six requirements specified in the subsection. Unlike sections 651 and 652 of the Bankruptcy Act, § 1325(a) of Title 11 does not require the consent of either secured or unsecured creditors.

[122]*See* Bowman & Thompson, *Secured Claims Under Section 1325(a)(5)(B): Collateral Valuation, Present Value, and Adequate Protection*, 15 IND. L. REV. 569 (1982); Comment, *Bankruptcy Reform Act of 1978: Chapter 13 Cramdown of the Secured Creditor*, 1981 WIS. L. REV. 333.

[123]11 U.S.C. § 1325(a)(4).

tion that provide only for payment of secured debts and no payment, or only minimal payment, of unsecured claims. At this juncture the numerous opinions of the courts considering such plans are in disarray as to whether they may be deemed to satisfy the standards of confirmation.[124]

Chapter 9 of the Bankruptcy Code provides for the adjustment of debts of a municipality,[125] defined to include any "political subdivision or public agency or instrumentality of a state."[126] The filing of a petition for relief under Chapter 9 triggers an automatic stay of the same scope as that provided by section 362 of Title 11, but in addition the stay operates against the enforcement of a "lien on or arising out of taxes or assessments owed to the debtor."[127] The provisions of Chapters 3, 5, and 11 that apply to holders of secured claims generally apply in Chapter 9 cases,[128] and their construction in Chapter 7 and particularly Chapter 11 cases may be assumed to be persuasive in Chapter 9 cases.

D. Discharge

Traditionally, discharge of a bankrupt has not barred the enforcement of a lien securing the debt.[129] The discharge has been viewed as affecting only the claim for a deficiency. Although an unfortunate phrase in section 524 has given rise to confusion in a few quarters,[130] the intention of Congress to leave the enforceability of a valid lien intact after discharge cannot be doubted.[131]

---

[124] *See* LoPucki, *"Encouraging" Repayment Under Chapter 13 of the Bankruptcy Code*, 18 HARV. J. OF LEGIS. 347 (1981); Note, *Chapter 13 De Minimis Plans: Toward a Consensus on "Good Faith,"* 9 HOFSTRA L. REV. 593 (1981); Note, *"Good Faith" and Confirmation of Chapter 13 Composition Plans: Analysis and a Proposal*, 65 MINN. L. REV. 659 (1981); Note, *Abusing Chapter 13 of the Bankruptcy Code: The Problem of Nonrepayment*, 55 N.Y.U.L. REV. 941 (1981); Comment, *Good Faith in Chapter 13: A New Wild Card for Bankruptcy*, 8 OHIO N.U.L. REV. 102 (1981); Note, *Filing For Personal Bankruptcy: Adoption of a "Bona Fide Effort" Test Under Chapter 13*, 14 U. MICH. J.L. REF. 321 (1981).

[125] 11 U.S.C. §§ 109(c), 941, 943.

[126] *Id.* § 101(29).

[127] *Id.* § 922.

[128] *See id.* § 901.

[129] *See* Long v. Bullard, 117 U.S. 617 (1886).

[130] 11 U.S.C. § 524(a): "A discharge . . . (2) operates as an injunction against the commencement . . . of an action, the employment of process, or any act, to collect . . . from property of the debtor." The court in *In re* Williams, 9 Bankr. 228 (D. Kan. 1981) held that the quoted language barred enforcement of a secured claim after discharge of the underlying debt.

[131] *See* H.R. REP. NO. 595, *supra* note 19, at 361, [1978] U.S. CODE CONG. & AD. NEWS at 5963; S. REP. NO. 989, *supra* note 85, at 76, [1978] U.S. CODE CONG. & AD. NEWS at 5787.

Only an individual is entitled to a discharge in a case under Chapter 7,[132] but the discharge obtainable by virtue of the confirmation of a Chapter 11 plan is comprehensive and practically absolute in the case of a corporate or partnership debtor.[133] An individual remains subject to the exceptions that apply in a Chapter 7 case,[134] but these are unlikely to be important so far as the enforcement of a secured claim is concerned. Thus a secured creditor is bound by the terms of a plan confirmed under Chapter 11, notwithstanding subsequent default in the performance of the executory features of the plan.

Confirmation of a Chapter 13 plan does not discharge the debtor. When the debtor completes all the payments under a confirmed Chapter 13 plan, however, the court ordinarily is required to discharge the debtor from all debts "provided for by the plan" except those for alimony, support, and maintenance and those not payable within the term of the plan.[135] Thus, any debt, whether secured or unsecured, that is not provided for by the plan survives the discharge granted under section 1528. Plans that omit any reference to a secured debt on the assumption that the debtor will maintain payments to the creditor subject the debtor to the risk that the underlying obligation remains unaffected by the discharge insofar as it becomes unsecured.[136] If the debtor does not complete payments under the plan, the court may nevertheless grant a limited discharge of the same scope as that obtainable in a Chapter 7 case if the debtor's failure to perform in full was due to circumstances for which the debtor is not justly accountable.[137] The effect of a discharge on a secured claim in a Chapter 13 case is not likely to be any different, whether it is a complete or limited discharge.

V. Conclusion

What is the net effect of the Bankruptcy Reform Act on the rights of secured creditors? The new law has been criticized for the degree to which it authorizes the bankruptcy court to impair those rights.[138] On the other hand it has been criticized for its failure to

---

[132]11 U.S.C. § 727(a)(1).

[133]*Id.* § 1141(d)(1).

[134]*Id.* § 1141(d)(2).

[135]*Id.* § 1328(a).

[136]*See* Countryman, *Letter to the Editor*, 85 Com. L.J. 28 (1980).

[137]11 U.S.C. § 1328(b), (c).

[138]*See* Eisenberg, *supra* note 88, at 955-71; Reisman, *The Challenge of the Proposed Bankruptcy Act to Accounts Receivable and Inventory Financing of Small-to-Medium-Sized Business*, 83 Com. L.J. 169, 174 (1978) ("[t]he proposed Bankruptcy Act would virtually negate the effectiveness of Article 9 security interests in bankruptcy proceedings . . . .").

constrain secured creditors' rights sufficiently to assure a fuller measure of attainment of the objectives of bankruptcy law.[139] The survey undertaken in this Article has suggested that the principal effect of the new law on secured creditors is to particularize and thus to clarify the ways in which their rights have been affected.[140] Undoubtedly the most dramatic effect can be found in Chapter 11, which authorizes the confirmation of plans of reorganization that may impair secured creditors' rights. Most business reorganizations attempted and effected under the Bankruptcy Act did not directly affect secured creditors' rights at all, because Chapter XI, by far the most frequently invoked reorganization chapter, could deal only with unsecured debts. This limitation, however, constituted a serious drawback in the usefulness of the chapter as a vehicle for enabling debtors in distress to develop viable reorganization plans.

Although the new act for the first time explicitly authorizes the use and disposition of property subject to security interests during the pendency of a case, the relevant statutory provisions codify prior case law more than they modify it or establish new law. Moreover, the new act recognizes in numerous contexts the secured creditor's right to "adequate protection" when his rights are or may be affected by exercise of the powers granted the bankruptcy court. Automatic stays of the exercise of secured creditors' rights are more fully elaborated in the new act than they were in the prior act, but much of this elaboration provides new limitations on the scope and operation of the stays and new safeguards of the secured creditor's rights. Not surprisingly, given the objectives of bankruptcy legislation, the trustee's rights to avoid liens against the debtor's

---

[139]*See* Gordanier, *The Indubitable Equivalent of Reclamation: Adequate Protection for Secured Creditors Under the Bankruptcy Code*, 54 AM. BANKR. L.J. 299, 299 (1980) ("[i]n facilitating business reorganizations, . . . the Code may prove to be no more successful than its predecessor, the Bankruptcy Act, and for the same reason: secured creditors have, practically speaking, a veto over many if not most of the plans proposed under chapter 11"); Note, *From Debtor's Shield to Creditor's Sword: Cram Down Under the Chandler Act and the Bankruptcy Reform Act*, 55 CHI.-KENT L. REV. 713 (1979).

[140]This theme with variations is elaborated in Coogan, *The New Bankruptcy Code: The Death of Security Interest?*, 14 GA. L. REV. 153 (1980). *See also* Committee on Developments in Business Financing, *Structuring and Documenting Business Financing Transactions Under the Federal Bankruptcy Code of 1978*, 35 BUS. LAW. 1645 (1980); Del Gaudio, *Article 9 of the Uniform Commercial Code and the Bankruptcy Reform Act of 1978*, 12 U. TOL. L. REV. 305 (1981); Massari, *Adequate Protection Under the Bankruptcy Reform Act* in ANNUAL SURVEY OF BANKRUPTCY LAW—1979 at 171 (W. Norton ed. 1979); Poe, *Further Thoughts on Secured Creditors Under the New Bankruptcy Code*, 28 EMORY L.J. 649 (1979); Rome, *The New Bankruptcy Act and the Commercial Lender*, 96 BANKING L.J. 389 (1979); Shanor, *A New Deal for Secured Creditors in Bankruptcy*, 28 EMORY L.J. 587 (1979).

property have been extended, but there are also changes cutting in the other direction.

The wisdom and worth of the new law must be judged in the light of experience—how well it works in practice. When Congress conferred pervasive jurisdiction on the bankruptcy court over proceedings arising under Title 11 and proceedings arising in or related to cases under Title 11 of the United States Code,[141] it was sensitive to the need to remove bankruptcy judges from involvement in matters of administration.[142] A principal consideration in adopting this reform was to assure secured creditors that their controversies with the trustee as the representative of unsecured creditors would be heard and determined by an impartial tribunal free from the influence that derives from continual contact with the administration of a case. The separation of judicial from administrative functions is, however, more an expression of an aspiration than a reality in nonpilot districts, where there are no United States trustees to assume and exercise necessary administrative responsibilities.[143] Moreover, the future of the pilot project is now imperiled because of efforts under way in Washington to eliminate the United States trustee program as a budgetary item in the appropriation for the Department of Justice. Whether the proper balance is drawn between the rights of secured creditors and the rights of unsecured creditors and debtors depends crucially on the judgment and discretion exercised by the bankruptcy judges. Congress has entrusted them with more judicial authority and responsibility than was ever granted them under prior legislation. If the need for separate administrative personnel can be met, the new dispensation should significantly enhance the effectiveness and efficiency of the bankruptcy system in rehabilitating distressed debtors as economic units and in facilitating the faster and fuller payment of their debts, both secured and unsecured.

---

[141]28 U.S.C. § 1471(b), (c) (Supp. III 1979).

[142]*See* 124 Cong. Rec. 32,410 (1978) (statement of Congressman Edwards); *id.* at 32,391 (statements of Congressman Butler); *id.* at 34,010, 34,018 (statements of Senator DeConcini); H.R. Rep. No. 595, *supra* note 19, at 101, 109-10, [1978] U.S. Code Cong. & Ad. News at 6062, 6070-71

[143]United States trustees are authorized to be appointed and to serve only in 18 judicial districts. 11 U.S.C. § 1501 (Supp. IV 1980); 28 U.S.C. § 581 (Supp. III 1979).

Confirmation of a Plan Under Chapter 11 of the Bankruptcy Code and the Effect of Confirmation on Creditors' Rights

EDWARD B. HOPPER, II*

I. INTRODUCTION

Despite the fact that the Bankruptcy Code[1] has been in effect since October 1, 1979, the ambiguities and areas of concern involving a Chapter 11 plan of arrangement or liquidation and the effect of the confirmation of that plan on creditor's rights is still a fertile area for speculation among bankruptcy practitioners and judges. By its very nature, Chapter 11 involves an often complex attempt to save a business through reorganization, which at a minimum usually requires one to two years. Due to this time lapse, there are few court decisions dealing with the problem areas that will be discussed in this Article. Therefore, we are relegated for the most part to the statute, legislative history, the prior Bankruptcy Act,[2] where applicable, and the cases under the Act, as well as a smattering of law review articles which have been written on new Chapter 11.

Because of the significant effect that the plan has on creditors, it is necessary to have an understanding of the steps leading to confirmation and how a debtor can affect creditor's rights, as well as how creditors' attorneys can and should protect their clients prior to confirmation. Chapter 11 of the Code is the reorganization chapter for partnerships, corporations, proprietorships, unincorporated associations and individuals.[3] Chapter 11 of the Bankruptcy Code contains attributes of the prior Bankrupcty Act Chapters X, XI and XII. Chapter 11 is correlative to the object of the old Chapters X, XI,

---

*Edward B. Hopper, II, Attorney, Partner in firm of Hopper & Opperman, Indianapolis, Indiana. Admitted to bar, 1964, Tennessee; 1967, Indiana. Education: Vanderbilt University, B.A., 1961; LL.B., 1964. Memberships: Indianapolis (Member, Board of Managers), Indiana State, Tennessee State, Federal and American Bar Associations, Bar Association of Seventh Circuit and Bar Association of the U.S. Supreme Court.

[1]Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549 (codified at 11 U.S.C. §§ 1101-151326 (Supp. IV 1980)) [hereinafter cited as the Code].

[2]Bankruptcy Act of 1898, 11 U.S.C. §§ 1-1103 (1976) (repealed October 1, 1979, Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, § 401(a), 92 Stat. 2549) [hereinafter cited as the Act].

[3]11 U.S.C. § 109 (Supp. IV 1980) defines who may be a debtor in a Chapter 11 proceeding, generally following former Act § 11(a)(1). *See* S. REP. No. 989, 95th Cong., 2d Sess. 31 (1978). *See also In re* Woodhouse, 11 Bankr. 322 (S.D. Ohio 1981) for the proposition that debtors as individuals are not prohibited from seeking relief under Chapter 11.

and XII in its application to beleaguered debtors seeking court protection from creditors attempting to force the liquidation of assets. Under Chapter 11, if reorganization is impossible at the outset of the case or is discovered to be impossible during the course of the attempt to reorganize, new Chapter 11 provides for a plan of liquidation without the necessity of converting the proceeding, as was necessary under the old Act.[4]

Often it is more economical from a creditor's standpoint to liquidate under Chapter 11 rather than to convert to a Chapter 7 proceeding for the reason that the creditor does not have to wait six months for claims to be filed as required in Chapter 7,[5] nor is there the expense of the trustee, his counsel, and possibly, accountants. In addition, the entities already involved in the proceedings, the debtor and the creditors' committee, control the liquidation subject to court approval without the interjection of a new party, the trustee, who must be educated concerning the debtor's affairs.

In the case of an operating business, once the Chapter 11 petition is filed, regardless of the voluntary or involuntary nature of the petition,[6] a new entity, the debtor-in-possession, is created and enters into the operating phase of the business.[7]

After the petition is filed and the operational phase of the case is underway, the object of the proceeding is usually to determine whether the debtor can operate the business involved paying its day-to-day costs of operation and generating cash to apply towards debt service required under secured creditors' contracts. Additionally, under close monitoring by the creditors' committee,[8] the debtor at-

---

[4]11 U.S.C. § 1123(a)(5)(D) (Supp. IV 1980) provides for a liquidating plan in a Chapter 11 case. Under the Act, there were cases which indicated that the trustee could liquidate under a Chapter X plan but no statutory provision existed for such a plan. *See* S. REP. NO. 1916, 75th Cong., 3d Sess. 34 (1938). *In re* American Bantum Cart Co., 193 F.2d 616 (3d Cir. 1952). This area of controversy is now put to rest in the Code.

[5]Bankruptcy Rule 302 wherein generally a claim must be filed within six months of the first date set for the first meeting of creditors. This rule continues to apply under the new code. *See* S. REP. NO. 989, 95th Cong., 2d Sess. 61, *reprinted in* [1978] U.S. CODE CONG. & AD. NEWS 5787, 5847.

[6]11 U.S.C. § 706(a) (Supp. IV 1980) provides for a conversion from Chapter 7 to Chapter 11 of the Code. Pursuant to 11 U.S.C. § 303(b) the creditors may file an involuntary Chapter 11 petition against a debtor. *See also In re* All Media Properties, Inc., 5 Bankr. 126 (S.D. Texas 1980), *aff'd*, 646 F.2d 193 (5th Cir. 1981).

[7]The powers and duties of a debtor in possession are defined in 11 U.S.C. § 1107(a) (Supp. IV 1980). For fiduciary responsibilities imposed by *id.* § 1107, *see In re* Antilles Yachting Inc., 4 Bankr. 470 (D.V.I. 1980). It is of consequence that the powers, rights, and duties of a debtor in possession are generally all rights of a trustee in a Chapter 7 proceeding.

[8]11 U.S.C. § 1102(a)(1) (Supp. IV 1980) provides the statutory authorization for

tempts to operate the business without losses on a weekly basis. Typically, if there is a positive cash flow, the debtor can determine what can be applied towards service on the secured debt and can approach the secured creditor or creditors with an interim proposal.[9]

The third phase of the Chapter 11 proceeding is the promulgation of the plan of arrangement. It is possible for the plan to be developed early in the case, which would allow the debtor-in-possession to accomplish phases two and three at the same time. The Code contemplates that the plan of arrangement typically be proposed by the debtor.[10] The plan is the debtor's program for settling with its creditors. After the exclusive debtor period has elapsed without an

---

the formulation of a creditors' committee. The rights, powers, and duties of the creditors' committee are set forth in *id.* § 1103(c). *In re* Western Management, Inc., 6 Bankr. 438 (W.D. Ky. 1980), succinctly defined the duties of the committees:

> Further, there is no indication in the record that the unsecured creditors' committee has met, investigated, monitored or in any other manner attempted to fulfill its statutory responsibility. It was envisioned by the drafters, when they removed the bankruptcy judge as overseer of a Chapter 11 case, that the committee would fill the void. Without the recommendations and findings of the creditors' committee, the Court, in ruling on a plan of reorganization, is confronted with a difficult, if not impossible, task in fulfilling its statutorily prescribed duties. It is vitally important that the Court be fully and accurately informed by independent reliable evidence. Neither the Court nor the creditors should be required to rely entirely on the evidence produced by the proponents of the plan.

Id. at 443. Judges in both the Southern District and Northern District of Indiana have adopted procedures which will become a local rule requiring the reporting of income and receipts for the 90 days preceding the filing of the petition and bi-monthly from the date of filing, using the form found in the Addendum at 544-46. The same form is used for the 90-day and bi-monthly reports.

The purpose of the reporting requirements is two-fold. Initially they protect the administrative creditor who can review the reports in the record in the bankruptcy court clerk's office to determine if it is in the best interest of a creditor to advance credit to the debtor in possession. Secondly, the reporting requirements allow the creditors' committee to determine whether the debtor's equity, if any, is deteriorating.

Additional protection is afforded the creditor who advances credit to a Chapter 11 debtor or a trustee for a Chapter 11 debtor under 11 U.S.C. § 364 (Supp. IV 1980) which gives the creditor an administrative claim and *id.* § 364(c) which authorizes the granting of a super priority over all other administrative creditors.

[9]11 U.S.C. §§ 361-364 (Supp. IV 1980) provides that creditors must be adequately protected during the pendency of the proceeding. Adequate protection can be a portion of the regular payment which compensates the creditor for the use of its collateral. *See also* Metropolitan Life Ins. Co. v. Murel Holding Corp. (*In re* Murel Holding Corp.), 75 F.2d 941 (2d Cir. 1935).

[10]11 U.S.C. § 1121(b) (Supp. IV 1980) gives the debtor the exclusive right to file a plan within 120 days from the date of the petition provided no trustee is appointed, and further, when read in connection with *id.* § 1121(c)(3), grants the debtor an additional 60 days to obtain confirmation.

extension by the court, any party in interest may file the plan.[11]

The practice of negotiating a plan with the creditors' committee, which was prevalent under Chapters X, XI and XII of the Bankruptcy Act, is carried on under new Chapter 11. In a case in which there is no trustee, once the plan has been negotiated to the satisfaction of the debtor-in-possession and the creditors' committee, the plan is then circulated among the creditor body. The use of a disclosure statement under the Bankruptcy Code serves to prevent circulation of so-called "blind plans" in which the creditors really do not know on what they are voting. The disclosure statement is devised to provide the creditor body with sufficient information so that a prudent decision can be made on whether acceptance of the plan is in the interest of a particular creditor.[12]

The next step involves the solicitation of votes from the creditor body for the purpose of obtaining confirmation of the plan.[13] Confirmation extinguishes all creditor rights beyond the terms of the plan itself against the debtor as those rights existed at pre-confirmation, with a few Code-defined exceptions discussed below.[14]

II. The Proposed Plan of Confirmation—A Quick Overview

Assuming that there is no trustee in the case, the debtor has the exclusive right to file a plan within 120 days after the filing of the case.[15] If a trustee is appointed in the Chapter 11 proceeding or if the debtor's proposed plan is not accepted within 180 days following the filing of the case,[16] any party in interest may file a plan.[17] It

---

[11]Pursuant to *id.* § 1121(c), after the exclusive period of time for filing the plan by the debtor, any party in interest may file a plan.

[12]*Id.* § 1125(a)(1) provides that a disclosure statement must contain

> information of a kind, and in sufficient detail, as far as is reasonably practicable in light of the nature and history of the debtor and the condition of the debtor's books and records, that would enable a hypothetical reasonable investor typical of holders of claims or interests of the relevant class to make an informed judgment about the plan. . . .

[13]*See id.* § 1126 for the requirements of acceptance of plan.

[14]*See id.* § 1141.

[15]*See id.* § 1121(b).

[16]The 180-day period includes 60 days for acceptance of the plan after the 120-day filing period.

[17]11 U.S.C. § 1121(c) (Supp. IV 1980) provides as follows:

> (c) Any party in interest, including the debtor, the trustee, a creditors' committee, an equity security holders' committee, a creditor, an equity security holder, or any indenture trustee, may file a plan if and only if—
>
> (1) a trustee has been appointed under this chapter;
>
> (2) the debtor has not filed a plan before 120 days after the date of the order for relief under this chapter; or
>
> (3) the debtor has not filed a plan that has been accepted, before 180

should be noted that on request of a party in interest, normally the debtor, and after notice and a hearing, the court may reduce or increase the 120-day period or the 180-day period.[18]

In most cases there should be no objection to the increase of the 120-day period if the creditors' committee realizes that the debtor is not in a position to file a plan at that time, but that there is a real possibility of a workable plan being filed in the future based on, for instance, refinancing or a sale, and there is no competing plan under consideration. The 180-day period should normally be extended when the debtor is not in a position to confirm the plan due to lack of funds or when the event which is to serve as the means for the execution of the plan, for example, a sale, cannot be closed for some reason. The only comment in the legislative history on the extension of the period appears at page 406 of the House Report where it is noted that "[c]ause might include an unusually large or unusually small case, delay by the debtor, or recalcitrance among creditors."[19] The Senate Report indicates that an extension should be granted only on the showing of some promise of probable success and not as a tactical device to pressure one of the parties negotiating the plan to yield and accept a plan they consider less than adequate.[20]

During this phase of the Chapter 11 case, the parties in interest, which typically include the debtor-in-possession and the creditors' committee, seek to formulate and work out a plan which specifies how much the creditors will be paid, the form of payment, and other details involving the reorganized debtor's business, such as interest that the stockholders will retain, who will manage the business, and in what form the reorganized debtor will continue.[21]

> days after the date of the order for relief under this chapter, by each class the claims or interests of which are impaired under the plan.

Query, is the court a party in interest? No provision of the Code has been read to place the court in that posture.

[18] *Id.* § 1121(d).

[19] H.R. REP. NO. 595, 95th Cong., 2d Sess. 406, *reprinted in* [1978] U.S. CODE CONG. & AD. NEWS 5963.

[20] S. REP. NO. 989, 95th Cong., 2d Sess. 118, *reprinted in* [1978] U.S. CODE CONG. & AD. NEWS 5787.

[21] See Addendum at 523-45 for sample plan and disclosure statement.

It is at this stage of the proceeding that a well represented creditor body has the most influence over the debtor. The committee has reviewed the financial reports with the debtor and has an estimation of the percentage which they would receive on their claims should they seek a conversion to Chapter 7. This knowledge is used both by the committee and the debtor in formulating a plan that the debtor can meet and that allows the creditors to maximize their recovery. Assume, for example, that the debtor proposed $0.20 settlement to unsecured creditors payable on confirmation. The creditors' committee is of the opinion that in liquidation creditors will receive 20 percent of their claims. The debtor's plan contemplates continuation of stock ownership as

After the negotiation of a satisfactory plan by the parties in interest, the next step is to solicit acceptances, which is the subject of section 1125 of the Code involving the preparation and circulation of a disclosure statement. The disclosure statement should contain sufficient information to enable the creditor to make an informed judgment whether to accept or reject the plan.[22]

There are some situations in which a disclosure statement would not be required, such as when a plan does not contemplate the solicitation of votes, leaving the secured creditors unimpaired, and proposing to cram down all other classes.[23] Additionally, a statement may not be required when the plan, in the opinion of the court, contains enough information to constitute adequate disclosure.[24]

There is an unsettled area involving the disclosure statement in a liquidating proceeding when a sale of the bulk of the assets of the debtor is proposed. The question arises whether the court should require an approved disclosure statement before the sale. One point of view is that the disclosure statement should be required because the sale is in reality the sole means for execution of the liquidation plan.[25] The contrary view is that a disclosure statement would be premature because creditors cannot be informed about the sum they are being offered in the liquidating plan until after the sale.[26]

With the intervention of the element of the disclosure statement in the proceeding, the Code also supplies the parties with insulation against future actions based on the disclosure statement, provided that the statement is approved by the court and is the sole basis upon which acceptance of the plan is solicited.[27]

---

it existed pre-petition. This may be the time to demand a percentage of the stock so that creditors share in any future success of the reorganized debtor.

[22]11 U.S.C. § 1125(b) (Supp. IV 1980). Regarding the contents of the disclosure statement, see Valley National Bank v. Trustee, 609 F.2d 1274 (9th Cir. 1981) in which the court refused to take a technical approach used in Securities and Exchange Commission proceedings to a disclosure statement in the bankruptcy proceeding. *But see In re* Cyr Bros. Meat Packing, Inc., 2 Bankr. 620 (D. Me. 1980) which requires that *full* disclosure be made.

There is also a question as to whether a notice fixing hearing on the approval of the disclosure statement need only provide that the disclosure statement is on file with the clerk of the court and may be reviewed there by any creditor.

[23]*See In re* Union County Wholesale Tobacco, 8 Bankr. 442 (D.N.J. 1981).

[24]*See In re* BelAir Assocs., 4 Bankr. 168 (W.D. Okla. 1981).

[25]*See In re* D.M. Christian Co., 7 Bankr. 561 (N.D. W.Va. 1981) (disclosure statement must be filed and approved prior to sale).

[26]*See In re* Whet, 12 Bankr. 743 (D. Mass. 1981) (sale permitted without disclosure statement).

[27]11 U.S.C. § 1125(e) (Supp. IV 1980) contains the well known "safe harbor" provision which insulates any person engaging in solicitation from possible violation of the securities act provided that the approved disclosure statement is relied upon.

After the disclosure statement has been approved, the plan, disclosure statement, and a ballot, which the court also typically approves, are circulated to the creditor body for voting. A class of claims as set forth in the plan will be deemed to have accepted the plan if the members of the class accept the plan by at least two-thirds in dollar amount, and more than one-half in number, of the allowed claims in the class.[28] If the rights of a class are deemed unimpaired by the debtor and the court accepts the debtor's position, the acceptance of that class is not required and the unimpaired class is deemed to have accepted the plan.[29] The claims of creditors who neither accept nor reject the plan are not considered in the vote. If objections to the disclosure statement or confirmation of the plan are not advanced by an individual member of a class, the member will be bound by the class vote.[30] If the proponent of the plan is not relying on section 1129(a)(8), which is the "cram down" provision discussed in greater detail below, every class deemed impaired under the plan must accept the plan by the requisite vote or have been deemed to have accepted the plan in order for the plan to be confirmed.[31]

The plan may be modified pre-confirmation by the proponent of a plan. The plan, as modified, becomes the confirmed plan only if, after notice and hearing, the court confirms the plan.[32]

III. Steps in the Confirmation Process

Assuming proper classification of claims or interests in the plan under section 1125 of the Code, and assuming the absence of an objection to confirmation under section 1128 of the Code, the court must find that the plan, in general, meets the following requirements:

1. that the plan and debtor comply with applicable provisions of Chapter 11;
2. all payments made in connection with or incident to the plan have been fully disclosed;

---

[28] *Id.* § 1126(c). *See also In re* Northwest Recreational Activities, Inc., 4 Bankr. 43 (N.D. Ga. 1980).

[29] 11 U.S.C. §§ 1126(f) & 1129(a)(8) (Supp. IV 1980).

[30] *Id.* § 1126(c). This section enforces the principle that creditors should respond to the solicitation notice.

[31] *Id.* § 1126(f).

[32] *Id.* §§ 1127, 1128. Immaterial modification may not require notification of all claims. *Id.* § 1127(c). Under *id.* § 1129(b) the court may allow confirmation if the plan is fair and equitable and does not discriminate unfairly. This provision was not a part of the Act and is a major change of the reorganization section of the Code. *In re* Winston Mills Inc., 1 C.B.C. 121 (S.D.N.Y. 1979). For the best interest of creditors test see treatment under the "cram down" section at text accompanying notes 45-56, *infra*.

3. principals and/or officers of the reorganized debtor have been disclosed;
4. that the plan has been proposed in good faith and not by any means prohibited by law;
5. the plan meets the best interest of creditors test;
6. each class has accepted the plan or is not impaired by the plan;
7. priority creditors are receiving the present market value of their claims;
8. at least one class of claims has accepted the plan;
9. confirmation is not likely to be followed by liquidation or further reorganization except as set forth in the plan.[33]

The debtor's disclosure requirements at confirmation, which are not to be confused with the disclosure statement discussed above, are set forth in section 1129(a)(4)(A) and (B). The proponent of the plan is obligated to disclose to the court any payment made or promise of payment to be made to any one connected with the issuance of securities under the plan or acquiring property under the plan for services or costs in connection with the plan or incident to the bankruptcy case. It is also required that the proponent of the plan indicate what compensation is to be paid to certain officers and key personnel of the debtor as a result of the plan.[34]

The four key steps in the above-described confirmation process are feasibility, good faith, best interest tests, and cram down.

A. *Feasibility*

The court must find that the debtor's plan is feasible. Under this standard, the court must determine from the evidence that the debtor can make its payments under the plan or perform under the plan. This is a significant juncture in the confirmation process for creditors. Counsel for the creditors' committee and individual creditors should be leery of plans which promise payments over time without a successful "track record" in the past, or on the basis of less than reliable projections. In the event that a debtor defaults under the confirmed plan, the creditor's sole remedy is to pursue the debtor

---

[33] 11 U.S.C. § 1129(a)(1)-(11) (Supp. IV 1980); *id.* § 1129(a)(2) indicates that Chapter 11 provisions have been complied with which would, for example, include the disclosure provisions. *Id.* § 1129(a)(3) indicates that the plan has been proposed in good faith and not by any means forbidden by law. For example, the plan cannot be proposed for the purpose of avoiding taxes or avoiding the Securities Act of 1933 as set forth in *id.* § 1129(d).

[34] *Id.* § 1129(a)(5). *See also* H.R. REP. No. 95-595, 95th Cong., 1st Sess. 408 (1977).

for the balance due *under the plan* through use of a new involuntary proceeding or normal non-bankruptcy collection remedies.[35]

B. Good Faith

The requirement that the proponent of the plan propose the plan in "good faith" is found in 11 U.S.C. § 1129(a)(3).[36] The good faith requirement is derived from sections 766(4)[37] and 621(3)[38] of the previous Act.[39] The requirement was interpreted under Chapter X to mean that there exists a real possibility of consummation of the plan.[40] The plan must also escape a finding by the court that it is part of a scheme to defraud creditors or other interest holders.[41]

The most scholarly description of the good faith requirement under the Act now applicable to the Code is found in the writings of the eminent jurist Judge John K. Rickles[42] in his article on good faith in Chapter X proceedings.

> One of the safest and soundest rules of construction of statutes is to consider the purposes of the legislation and not be lost in a cosmic nebula of theory. Judges are realistic men and matters common to mankind are not foreign to them. In approving a Chapter X petition, a district judge will be governed by the information furnished him by the debtor, secured and unsecured creditors, stockholders, bondholders and other parties in interest. He will inquire as to how and why the business came into difficulty, what the difficulty was, the present condition of the business and the property,

---

[35]11 U.S.C. § 1129(a)(11) (Supp. IV 1980) stipulates that "[c]onfirmation . . . is not likely to be followed by liquidation, or the need for further financial reorganization, of the debtor or any successor of the debtor under the plan, unless such liquidation or reorganization is proposed in the plan." *Id.* § 1129(a)(11) provides a new feasibility standard. *See also In re* Northwest Recreational Activities, Inc., 4 Bankr. 43 (N.D. Ga. 1980). Consolidated Rock Products Co. v. Du Bois, 312 U.S. 510 (1941), indicated that evidence which could be presented by the debtor if the debtor was the proponent of the plan included past earnings history, change in policies, operations, financial projections with supportive assumptions, and appraisals. In *In re* Landmark Plaza Park Limited, 7 Bankr. 653 (D.N.J. 1981), the court refused to confirm a plan on the finding that the projection of future income necessary to make the payments was unduly optimistic.

[36]11 U.S.C. § 1129(a)(3) (Supp. IV 1980).

[37]11 U.S.C. § 766(4) (1976) (repealed 1978).

[38]*Id.* § 621(3).

[39]28 U.S.C. § 764(4) (old Act Chapter XI); 28 U.S.C. § 621(3) (old Act Chapter X).

[40]6A Collier on Bankruptcy ¶ 11.08, at 243 (14th ed. L. King 1977).

[41]*See* Price v. Spokane Silver & Lead Co., 97 F.2d 237 (8th Cir.), *cert. denied*, 305 U.S. 626 (1938), for an early view of the principle.

[42]United States Bankruptcy Court of the Southern District of Indiana.

> whether there is a fair prospect that the business can be continued, what other proceedings are pending, etc. That information will be the basis of his findings of good faith, or the lack of it.[43]

Under the provisions relating to the good faith requirement, this requirement must be distinguished from the principle that the petition be filed in good faith.[44]

C. *The Best Interest of Creditors Test*

The best interest of creditors provisions are set forth in 11 U.S.C. § 1129(a)(7). The best interest of creditors test parallels in part the requirements of the provision for "cram down," treated below, and the provision known as the absolute priority rule under Chapter X. The test as set forth under the Code appears to have been interpreted as requiring a higher standard than that required under Chapters X or XI of the Act in that the creditors must receive at least as much as they would receive in liquidation (under Chapter 7), and creditors of a senior class must receive proper treatment before a junior class can share in distribution under the plan. In the case of *In re Winston Mills, Inc.*[45] the bankruptcy judge examined section 1129(a)(7) in comparison to the requirements under the Act and concluded that the Code's standard is more stringent:

> "When a plan of arrangement offers creditors considerably less than they would realize through liquidation, the plan should not be regarded as being in the best interests of the creditors." . . .
>
> It would serve little purpose to examine with minute care the evidence offered by the debtor on the issue of satisfaction of the legal standard described above.
> (Footnote 6: Section 1129(a)(7) of the 1978 Code, not applicable to this Chapter XI case . . . insures "that the dissenting members of an accepting class will receive at least what they would otherwise receive . . ." 124 Cong. Rec. [daily ed. September 28, 1978]. The 1978 Code Chapter 11 standard seems stricter than is suggested by the adverb modifier "considerably" in the quoted material in the text above.[46]

---

[43]Rickles, *What is "Good Faith" in Chapter X Proceedings?*, 29 J. OF THE NAT'L A. OF REFEREES IN BANKR. 60, 62 (1955).

[44]Hadley v. Victory Constr. Co. (*In re* Victory Constr. Co.), 9 Bankr. 570 (C. D. Cal. 1981).

[45]1 C.B.C.2d 121 (S.D.N.Y. 1979).

[46]*Id.* at 125.

It would appear that sections 1129(a)(7)[47] and 1129(b)(1) and (2), the so-called "cram down" section, will be the most controversial sections in Chapter 11 for the reason that both give rise to historically difficult questions of valuation.

D. Cram Down

"Cram down" applies to the stockholder class as well as to the classes of creditors who may be objecting to the plan. The cram down provision arises out of 11 U.S.C. § 1129(b)(1), which provides that:

> if all of the . . . requirements of subsection (a) of this section other than paragraph (8) are met with respect to a plan, the court, on request of the proponent of the plan, shall confirm the plan . . . if the plan does not discriminate unfairly, and is fair and equitable, with respect to each class . . . ."[48]

---

[47] 11 U.S.C. § 1129(a)(7) (Supp. IV 1980) provides that the court can confirm only if:

> With respect to each class—
> (A) each holder of a claim or interest of such class—
> (i) has accepted the plan; or
> (ii) will receive or retain under the plan on account of such claim or interest property of a value, as of the effective date of the plan, that is not less than the amount that such holder would so receive or retain if the debtor were liquidated under chapter 7 of this title on such date; or
> (B) if section 1111(b)(2) of this title applies to the claims of such class, each holder of a claim of such class will receive or retain under the plan on account of such claim property of a value, as of the effective date of the plan, that is not less than the value of such creditor's interest in the estate's interest in the property that secures such claims.

[48] *Id.* § 1129(b)(1).

The legislative explanation of section 1129(b)(1) reads:

> Subparagraph (C) applies to a dissenting class of impaired interests. Such interests may include the interests of general or limited partners in a partnership, the interests of a sole proprietor in a propieetorship, [sic] or the interest of common or preferred stockholders in a corporation. If the holders of such interests are entitled to a fixed liquidation preference or fixed redemption price on account of such interests then the plan may be confirmed notwithstanding the dissent of such class of interests as long as it provides the holders [sic] property of a present value equal to the greatest of the fixed redemption price, or the value of such interests. In the event there is no fixed liquidation preference or redemption price, then the plan may be confirmed as long as it provides the holders of such interest property of a present value equal to the value of such interests. If the interests are "under water" then they will be valueless and the plan may be confirmed notwithstanding the dissent of that class of interests even if the plan provides that the holders of such interests will not receive any property on account of such interests.
>
> Alternatively, under clause (ii), the court must confirm the plan notwithstanding the dissent of a class of interests if the plan provides that holders of any interests junior to the dissenting class of interests will not receive or retain any property on ac-

Irving D. Labovitz indicates in his excellent article on cram down that:

> "Cram Down" becomes an issue only when all necessary statutory requirements for confirmation of a plan have been achieved, except that one or more classes of claims, or other parties at interest, have refused to accept the proposed plan. It is these dissident classes that *may* become the subject of imposition of the Plan, or of a "Cram Down" of the Plan against their wishes by a debtor. The "Cram Down" tests and rules to be discussed in this outline must be distinguished from the prerequisites of confirmation otherwise encumbent upon any Chapter 11 proceeding, including compliance with statutory directives under the proposal of the Plan in a lawful and good faith manner, certain disclosure requirements, and compliance with the statutory "best interests of creditors test."[49]

In a cram down situation, secured creditors must receive deferred payments totalling at least the allowed amount of their claim and the payments must be equivalent to the present market value of their claim. Unsecured creditors must either receive full compensation or deferred compensation equivalent to their claim or, if less than full compensation is provided by the plan, no junior class can receive or retain any interest in the debtor's property.

The cram down provision applies to secured creditors, unsecured creditors, and equity holders. Cram down, although new to those who worked with Chapter 11 of the Bankruptcy Act, was available under the Act in Chapter X, and as a new tool should be used sparingly. However, it should allow confirmation of plans facing recalcitrant creditors or groups.[50]

Examples of cram down situations appear in several excellent law review articles.[51] In reviewing these articles, consider first the

---

count of such junior interests. Clearly, if there are no junior interests junior to the class of dissenting interests, then the condition of clause (ii) is satisfied. The safeguards that no claim or interests receive more than 100% of the allowed amount of such claim or interests and that no class be discriminated against unfairly will insure that the plan is fair and equitable with respect to the dissenting class of interests. *See* 124 CONG. REC. 32408 & 34007 (1978).

[49]Labovitz, *Outline of "Cram Down" Provisions Under Chapter 11 of the Bankruptcy Reform Act of 1978*, 86 COM. L.J. 51 (1981).

[50]For examples of "cram down" of secured creditors in Chapter 13 cases which are analogous to Chapter 11, *see* General Motors Acceptance Corp. v. Lum (*In re* Lum), 1 Bankr. 186 (D. Tenn. 1980); *In re* Crockett, 3 Bankr. 365 (N.D. Ill. 1980).

[51]*See, e.g.*, Klee, *All You Ever Wanted to Know About Cram Down Under the New Bankruptcy Code*, 53 AM. BANKR. J. 133, 146-71; Labovitz, *supra* note 49, at 54-56.

following two examples based on a simple fact situation which may clarify how the relevant complex legislative authorities are to be interpreted.

Assume the "ever-present" bank holds a mortgage on the debtor corporation's real estate in the sum of $500,000.00 and the real estate has a market value of $450,000.00. The debtor owns equipment and inventory having a market value (on re-sale to a willing buyer) of $100,000.00, free of liens. There are tax claims of $60,000.00 and an unsecured trade debt of $300,000.00.

Under 11 U.S.C. § 1129(b), a plan which proposes to pay the bank $450,000.00 over twenty years at a current rate of interest could be "crammed down" over the bank's objection to confirmation of the plan.[52] Tax claims can be proposed to be paid over six years, on a pro rata basis, at the statutory rate of interest and this class will be deemed to have accepted.[53] For unsecured creditors, if the plan offers $40,000.00, $20,000.00 on the date of confirmation and $20,000.00 in notes, at the current market rate of interest to be paid over five years, the court can confirm the plan over a vote rejecting the plan since unsecured creditors are being paid not less than they would receive under a Chapter 7 liquidation.[54] Upon acceptance by one class under the plan, the other classes can be "crammed down."[55]

To reiterate, the "cram down" provision applies to secured creditors, unsecured creditors, and stockholders. A rejecting class of stockholders cannot block a plan where the going concern value of the business is less than the amount of the debt.[56]

---

[52]*See* 11 U.S.C. § 1129(b)(1) (Supp. IV 1980). A "cram down" provision existed under Chapter X which defined "adequate protection". 11 U.S.C. § 616(7) (1976) (repealed 1978).

[53]*Id.* § 1129(a)(9)(C).

[54]$100,000 (inventory and equipment) minus $60,000 (taxes) equals $40,000 (pot for general creditors minus expense of the Chapter 7 proceeding).

[55]11 U.S.C. § 1129(a)(10) (Supp. IV 1980). *But see* Buffalo Savings Bank v. Marston Enterprises, Inc. (*In re* Marston Enterprises, Inc.), 13 Bankr. 514 (E.D.N.Y. 1981); *In re* Landau Boat Co., 13 Bankr. 788 (W.D. Mo. 1981).

[56]It is determined at the hearing on the stockholder's objection to confirmation that the value of the reorganized debtor is $5,000,000 based on the fact that earnings minus return to the investor is $1,000,000 at a market rate of 20%. The debt then exceeds the value to the detriment of the stockholders.

Excellent discussion of cram down and examples of fact situations to which it may be applicable appear in Klee, *All You Ever Wanted to Know About Cram Down Under the New Bankruptcy Code*, 53 AM. BANKR. L.J. 133 (1979). *See also* Labovitz, *supra* note 49.

IV. Effect of Confirmation on Creditors

Generally, confirmation does the following for the debtor:

1. Confirmation of the plan is binding on creditors of the debtor, whether or not they accept the plan or have claims which are impaired.
2. The Chapter 11 debtor, if it is a corporation, is discharged from all pre-petition debts except to the extent provided for in the plan.
3. Finally, the debtor, upon confirmation, is revested with all property of the debtor-in-possession free and clear of all claims except as provided for in the plan.

The significant change in the effect of confirmation from old Chapter XI is that the reorganized debtor is insulated from being pursued by creditors who formally asserted non-dischargeable claims. Whether the claim was scheduled or whether the debtor had committed an act giving rise to a non-dischargeable claim under Chapter 7 are matters which no longer concern the debtor post-confirmation.[57]

---

[57] 11 U.S.C. § 1141 (Supp. IV 1980) provides in part:

> (d)(1) Except as otherwise provided in this subsection, in the plan, or in the order confirming the plan, the confirmation of a plan—
>
> (A) discharges the debtor from any debt that arose before the date of such confirmation, and any debt of a kind specified in section 502(g), 502(h), or 502(i) of this title, whether or not—
>
> (i) a proof of the claim based on such debt is filed or deemed filed under section 501 of this title;
>
> (ii) such claim is allowed under section 502 of this title; or
>
> (iii) the holder of such claim has accepted the plan; and
>
> (B) terminates all rights and interests of equity security holders and general partners provided for by the plan.
>
> (2) The confirmation of a plan does not discharge an individual debtor from any debt excepted from discharge under section 523 of this title.
>
> (3) The confirmation of a plan does not discharge a debtor if—
>
> (A) the plan provides for the liquidation of all or substantially all of the property of the estate;
>
> (B) the debtor does not engage in business after consummation of the plan; and
>
> (C) the debtor would be denied a discharge under section 727(a) of this title if the case were a case under Chapter 7 of this title.

Similar provisions were found in the Act. Collier's treatise discusses section 224(1) of the Bankruptcy Act in regard to the Chapter X proceeding:

> Paragraph (1) of § 224 is derived from former § 77B(h) and provides that upon confirmation of a plan, "the plan and its provisions shall be binding upon the debtor, upon every other corporation issuing securities or acquiring property under the plan, and upon all creditors and stockholders, whether or not such creditors and stockholders are affected by the plan or have accepted it or have filed proofs of their claims or interests and whether or not their claims or interests have been scheduled or allowed or are allowable".

6A Collier on Bankruptcy ¶ 11.13 at 273 (rev. ed. 1981).

Section 1141, discharging the debtor from all pre-petition claims, makes plain sense when read in light of section 1129, which allows the court to confirm a plan over objections of creditors, provided that the plan is in the best interests of creditors and that the creditors are receiving no less than they would receive under Chapter 7.[58] In light of the foregoing, secured creditors, mortgage holders, and mechanics' lien holders should be especially wary because secured creditors' rights can be changed and terminated as a part of the plan. If the plan does not provide for preservation of the lien, and the plan is confirmed, the lien is eradicated.[59]

The effect of confirmation is important to holders of non-dischargeable claims under 11 U.S.C. § 523 since these claims will not survive confirmation. The holders may be well advised to seek conversion of the proceeding to a Chapter 7 or to attempt to force the filing of a liquidation plan. The concern stems from the effect of the discharge on the creditors' rights against a co-maker, guarantor, or surety of a debt which has been extinguished by the plan.[60]

A. *Revocation of Confirmation*

On timely request of a party in interest, the court may revoke any order of confirmation obtained by fraud, which would also revoke the discharge, leaving the remedies of creditors as they existed pre-confirmation.[61] The change from prior law is that section

---

[58]*Cf.* 11 U.S.C. §§ 371 & 476 and Bankr. R. 11-43, 12-42 (Chapters XI and XII discharges apply only to § 17 dischargeable debts). *See also* Jay Law Drug, Inc. v. United States I.R.S. (*In re* Jay Law Drug, Inc.), 621 F.2d 524 (2d Cir. 1980) dealing with the rights of the holders of non-dischargeable claims against the debtor post-confirmation. The expanded dischargeability concept does not apply to individuals or to Chapter 11 liquidations.

[59]*In re* Williams, 9 Bankr. 228, 232 (D. Kan. 1981) (once debt underlying lien is extinguished by discharge, lien is unenforceable). *See also* BANKR. SERV. (L. Ed.) § 171, at 82 (1979).

[60]*See* 11 U.S.C. §§ 366(3) & 472(3) (1976) as well as Bankr. R. 11-38, 12-38 describing the circumstances which would bar confirmation under the Act if the debtor committed an act which would bar the discharge. *See also* 11 U.S.C. § 1144 (Supp. IV 1980).

[61]11 U.S.C. § 1144 (Supp. IV 1980) provides in part:

> On request of a party in interest at any time before 180 days after the date of the entry of the order of confirmation, and after notice and a hearing, the court may revoke such order if such order was procured by fraud. An order under this section revoking an order of confirmation shall—
>
> (1) contain such provisions as are necessary to protect any entity acquiring rights in good faith reliance on the order of confirmation; and
>
> (2) revoke the discharge of the debtor.

Of special importance is the time limitation imposed of 180 days. Notice and a hearing is required. Revocation is discretionary in Chapter 11, while mandatory under Chapter 7. *Id.* § 727(d).

1144 confines the fraud to one area, specifically, fraud in obtaining confirmation of the plan, after filing. No longer is there significance to the perpetration of fraud, either pre-filing or post-filing, which would have been a bar to discharge under Chapter XI of the Act.

B. *Modification of a Plan Post-Confirmation*

Post-confirmation modification of the plan is provided for in section 1127.[62] Section 1127(b) enables modification of the plan to take place after confirmation but before substantial consummation of the plan.[63] According to the Collier treatise,[64] section 1127(b) essentially incorporates into Chapter 11 Bankrupcty Rule 10-306(b) as it applied to modification of Chapter X plans. When the modification of the plan occurs, it is as if the proponent of the plan has filed a new plan. The proponent must go through the same steps required of a proponent with regard to the original plan unless the modification deals only with one class, in which case the steps need deal only with that class.[65]

C. *Treatment of Tax Claims in Chapter 11*

An important change from the Bankruptcy Code occurred when Congress adopted section 1129(a)(9)(C), which allows the debtor to spread tax claims over a six year period from the date of assessment of the tax claim as a part of the plan.[66] As long as the

---

[62]*Id.* § 1127 provides in part:

> (b) The proponent of a plan or the reorganized debtor may modify such plan at any time after confirmation of such plan and before substantial consummation of such plan, but may not modify such plan so that such plan as modified fails to meet the requirements of sections 1122 and 1123 of this title. Such plan as modified under this subsection becomes the plan only if the court, after notice and a hearing, confirms such plan, as modified, under section 1129 of this title, and circumstances warrant such modification.
>
> (c) The proponent of a modification shall comply with section 1125 of this title with respect to the plan as modified.
>
> (d) Any holder of a claim or interest that has accepted or rejected a plan is deemed to have accepted or rejected, as the case may be, such plan as modified, unless, within the time fixed by the court, such holder changes such holder's previous acceptance or rejection.

[63]*Id.* § 1127(b). *Id.* § 1101(2)(B) provides that substantial consummation means: "[a]ssumption by the debtor or by the successor to the debtor under the plan of the business or of the management of all or substantially all of the property dealt with by the plan. . . ."

[64]5 Collier on Bankruptcy ¶ 1127.02, at 1127-4 (15th ed. L. King 1981).

[65]*Id.* ¶ 1127.03, at 1127-4. Query, does post-petition modification reopen the 180-day period under 11 U.S.C. § 1144 to revoke the original confirmation order?

[66]11 U.S.C. § 1129(a)(9)(C) provides:

> with respect to a claim of a kind specified in section 507(a)(6) of this ti-

reorganized debtor is making its payments under the plan, the taxing authorities cannot take action against the new entity.

D. Post-Confirmation Objections to Claims

An obvious question under the Code is that of when objections to disputed claims must be filed. Under the Bankruptcy Rules, the creditor who has a disputed claim must file the claim before the approval of the disclosure statement. Assuming that the holder of the disputed claim filed a claim pursuant to the Rule, the question is then one of when must the debtor-in-possession or the reorganized debtor file an objection to the claim. A proper interpretation of the statute seems to indicate that an appropriate objection can be lodged by the reorganized debtor after the order of confirmation has been entered. Chapters 1, 3, 5 and 11 of the Bankruptcy Code prescribe the time period in which the trustee or the entity acting as trustee in the proceeding must file objections to claims with the exception of section 502(g).

From a practical point of view, an interpretation that objections to claims must be filed before an order of confirmation is entered would render the chapter unworkable in many situations, because claims may be filed by creditors up until the time the court enters its order of confirmation. It is also conceivable that Chapter 11 proceedings may be required in order to confirm a plan which had been worked out between the creditors and the debtor prior to the filing. Some claims, such as claims of the Internal Revenue Service, require filing of the Chapter 11 proceeding in order to proceed with the program worked out between the creditors and the debtor. A plan filed with the petition could conceivably be confirmed within 45 to 60 days. With claims being filed until the date of confirmation, it is probable that the debtor would not review the claims until after confirmation. Therefore, there would be no time limitation in the chapter for the filing of objections to claims absent a court order directing the debtor to object to claims by or before a particular date.

Under the old Chapter XI, section 369 specifically provided that the court retain jurisdiction until the final allowance or disallowance of all claims. This provision was required because under old Chapter XI, claims had to be filed by all parties in interest and if claims were not filed by the date of confirmation, an additional 30 days

---

tle, the holder of such claim will receive on account of such claims deferred cash payments, over a period not exceeding six years after the date of assessment of such claim, of a value, as of the effective date of the plan, equal to the allowed amount of such claim.

were provided for the filing of claims. However those claims were limited by the amount scheduled by the debtor. Under the old Chapter X, neither section 196 nor Rule 10-40(f) limited the time in which the trustee could object to claims. The claim procedures under the old Chapters X and XI were merged and carried on under new Chapter 11.[67] This to some extent explains why there is no provision in the Code limiting the court's jurisdiction to hear and determine claims. The Code contains broad language directing the debtor to follow the orders of the court.[68]

Traditionally, the courts have viewed the order of confirmation in a reorganization case as merely a step in the administration of the estate. Confirmation of the plan in no way interfered with the jurisdiction of the court to see that the plan was consummated.[69] Nothing divested the court of jurisdiction over the debtor's plan until the plan was consummated and a closing order entered.[70] The case terminated on the entry of the final decree.[71]

E. The Position of the Unscheduled Creditor Post-Confirmation

The holder of an unscheduled claim without knowledge of the Chapter 11 proceeding will probably pursue the debtor post-confirmation. Subsection (d) of section 1141 provides as follows:

> (d)(1) Except as otherwise provided in this subsection, in the plan, or in the order confirming the plan, the confirmation of a plan—
>
> (A) discharges the debtor from any debt that arose before the date of such confirmation, and any debt of a kind specified in section 502(g), 502(h), or 502(i) of this title, whether or not—
>
> (i) a proof of the claim based on such debt is filed or deemed filed under section 501 of this title;

---

[67] *In re* Oakton Beach & Tennis Club, 9 Bankr. 201 (E.D. Wis. 1981).

[68] For post-confirmation provisions, see 11 U.S.C. § 1142 (Supp. IV 1980). There are no Chapter 11 cases known to the author on the subject of the trustee's timely objection to claims, but this question is treated in a Chapter 13 context in *In re* Harris, 2 Bankr. 369 (D.D.C. 1980).

[69] *See* Standard Gas & Elec. Co. v. Taylor (*In re* Deep Rock Oil Corp.), 113 F.2d 266 (10th Cir.), *cert. denied*, 311 U.S. 699 (1940); Wright v. City Nat'l Bank & Trust Co., 104 F.2d 25 (6th Cir. 1939). *See also* North American Car Corp. v. Peerless Weighing & Vending Mach. Corp., 143 F.2d 938 (2d Cir. 1944).

[70] *See* North American Car Corp. v. Peerless Weighing & Vending Mach. Corp., 143 F.2d 938 (2d Cir. 1944).

[71] *See* Rule 3010 of the Bankruptcy Rules of the United States Bankrupty Court, Southern District of Indiana.

(ii) such claim is allowed under section 502 of this title; or

(iii) the holder of such claim has accepted the plan; and

(B) terminates all rights and interest of equity security holders and general partners provided for by the plan.

2) The confirmation of a plan does not discharge an individual debtor from any debt excepted from discharge under section 523 of this title.

(3) The confirmation of a plan does not discharge a debtor if—

(A) the plan provides for the liquidation of all or substantially all of the property of the estate;

(B) the debtor does not engage in business after consummation of the plan; and

(C) the debtor would be denied a discharge under section 727(a) of this title if the case were a case under chapter 7 of this title.[72]

Section 502(g) refers to claims arising out of a rejection of executory contract;[73] section 502(h) deals with the recovery of property by the debtor for an avoidable transfer or as a result of an avoidable preference;[74] and section 502(i) deals with tax claims entitled to priority which arise after the commencement of the case.[75] Section 1141(d)(3)(C) deals only with individual debtors and involves the provisions of section 727(a) which would bar a discharge of the debtor if the case arose under Chapter 7.[76]

---

[72] 11 U.S.C. § 1141(d) (Supp. IV 1980).

[73] *Id.* § 502(g) provides:

A claim arising from the rejection, under section 365 of this title or under a plan under chapter 9, 11, or 13 of this title, of an executory contract or unexpired lease of the debtor that has not been assumed shall be determined, and shall be allowed under subsection (a), (b), or (c) of this section or disallowed under subsection (d) or (e) of this section, the same as if such claim had arisen before the date of the filing of the petition.

[74] *Id.* § 502(h). This section deals with claims which arise from property recoveries under 11 U.S.C. §§ 522(i), 550, and 553 (Supp. IV 1980). Section 522(i) deals with debtor's avoidance of a transfer or recovery of a setoff. Section 550 addresses the liability of the transferee vis-a-vis the debtor's efforts to avoid. Section 553 concerns the rights of a creditor to offset mutual debt.

[75] *Id.* § 502(i).

[76] 3 COLLIER ON BANKRUPTCY, ¶ 523.03, at 523-8 to -9 (15th ed. L. King 1981) provides:

Section 523 specifically excepts certain debts from discharges granted under section 727, 1141 and 1328(b). Nine types of debts are enumerated as excepted from discharge of "an individual debtor." It must be particularly noted that section 523 applies only to individual debtors. . . . In a reorganization case under Chapter 11, while confirmation of a plan discharges the "deb-

For unscheduled claims, section 1141(d)(1)(A)(i) provides that the discharge occurs whether or not a claim was filed or deemed filed pursuant to section 501 of the Code. It is clear from this portion of the statute that an unscheduled claim is discharged under a confirmed plan, insofar as the corporate debtor, partnership, or unincorporated association is concerned. Section 523(a)(3) would, if applicable, bar the discharge of an unscheduled claim under the confirmed plan of arrangement. However, that section is not applicable to a Chapter 11 plan under the provisions of section 1141.

F. The Tort Claim—Insurance Coverage—Ability to Pursue the Carrier Post-Confirmation

Consider a situation in which the debtor operated a number of convenience stores. Prior to the debtor's filing under Chapter 11, an employee of the debtor is killed during a robbery of one of the stores and the estate feels that it has a claim based upon the decedent's employer's failure to provide her with a safe place to work which would have protected the deceased from acts of violence. A Chapter 11 proceeding was filed in May of 1980 and the schedules did not include any claim, contingent or disputed, of the deceased or the estate. The administrator had no actual knowledge of the bankruptcy proceedings and seeks to bring suit against the insurance company who insured the debtor pre-petition by filing an adversary proceeding against the reorganized debtor in the Chapter 11 proceeding after confirmation. The action against the reorganized debtor is brought approximately one year after the proceeding had been initiated by a voluntary petition and eight months after the plan of arrangement had been confirmed. Query whether the order of confirmation discharging the debtor from liability to the unscheduled creditor also discharges the insurance company. Indiana Code section 27-1-13-7 seems to provide that a discharge in bankruptcy of the insured will not affect the liability of the carrier.[77]

In a case in which the plaintiff in the suit against the personal injury carrier clearly prejudices the insurance company by failing to file a claim in the Chapter 11 proceeding, especially where a plan provides for fairly high dividend or perhaps 100% repayment, is the exposure of the insurance company lessened by the amount the debtor failed to collect from the Chapter 11 proceeding? There are no authorities on the subject, but clearly there appears to be exposure

---

tor." (which may be an individual, partnership or corporation) it is specifically provided that confirmation of a plan does not discharge an individual debtor from any debt excepted from discharge under section 523.

[77]*See* IND. CODE § 26-1-13-7 (1976).

here created by the failure to file a claim in the Chapter 11 proceeding, regardless of the Indiana statute.

G. Failure to Perform by the Reorganized Debtor Post-Confirmation

If the new entity as a result of confirmation fails to perform under the plan, what is the amount of debt due a creditor affected by the plan and what are the remedies of the creditor? The amount of debt due the creditor faced with a reorganized debtor's failure post-confirmation and pre-substantial consummation of the plan is the balance due and unsatisfied under the plan.[78]

---

[78]*See* 11 U.S.C. § 1144 (Supp. IV 1980); *see also In re* Stratton Group, Ltd. 12 Bankr. 471 (S.D.N.Y. 1981).

In the *Stratton* case, Judge Babbit discussed the subject of the amount due the creditor post-confirmation under Chapter XI of the Act, finding that the dissatisfied creditor's claim against the defaulting debtor now in straight bankruptcy was the balance due under the confirmed plan of arrangement. The principles set forth in *Stratton* apply to a case under the Code.

> Thus, when Congress, in Section 371, defined the confirmation discharge to release the rehabilitated debtor from all his unsecured debts provided for by the plan, Congress gave meaning to its policy of affording debtors rehabilitation and a fresh start. Confirmation fixes the reach of claims that are allowed and that the debtor treats in the plan. Where the debtor effects a composition, he is relieved of his old debts and simply has the burden of achieving the promises made in the composition. The composition thus operates as an absolute settlement, and the failure to pay unpaid obligations created by the plan will not revive the old debts. *Jacobs v. Fensterstock, supra,* citing In re Mirkus, 289 F. 732 (2d. Cir. 1923). In the composition plan, the creditor receives what he bargained for there and has no right to claim more. In re Lane, 125 F. 772 (D.C. Mass. 1902). There is nothing in the Act to suggest that the debtor's failure to achieve promises made in a confirmed plan reinstates an original obligation. In re Setzler, 73 F. Supp. 314 (D.C. Cal. 1947). It would take a much clearer expression by Congress to enforce a policy wherein a debtor who unsuccessfully attempts to rehabilitate himself and benefit his creditors through a confirmed plan finds himself obligated for the original amount of the debts, whereas a straight bankrupt is discharged of all his obligations.
>
> While the question is not entirely free from doubt, this court's conclusion finds support in the language of section 371. The phrase "unsecured debts and liabilities provided for by the arrangement" obviously means the treatment given the debts by the plan and not, as Elco would have it, the amount actually promised. The word "debt" is defined by Section 1(14), 11 U.S.C. (1976 ed.) § 1(14), to mean the totality of an obligation which may be asserted in a proceeding under the Act. These are the debts provided for in the debtor's plan and discharged by confirmation. How the debtor composes them in the plan and how the debtor achieves his promises is something else.
>
> Accordingly, in this dispute, that something else merely means that Elco is entitled to its 35% less what it was paid. The 65% of its original debt was released by the discharge of the confirmation and the trustee in

If there is no subsequent voluntary Chapter 7 or 11 filing by the reorganized debtor, what remedies are available to the creditor to seek recovery of the balance due under the unconsummated plan? Clearly the creditor is relegated to filing suit on the debt in the appropriate non-bankruptcy forum, initiating an involuntary proceeding under Chapter 7 or 11, or seeking modification of the plan under 11 U.S.C. § 1127, which has yet to be interpreted by any court.

V. Conclusion

As can be seen from the foregoing discussion, the confirmation of a plan under Chapter 11 has a devastating effect on creditors' rights against a debtor. Creditors must be involved in the Chapter 11 case whether the task is palatable to them or not. They must be sure that any rights that they have under a contractual agreement are safeguarded if deemed valuable and that they understand the plan of arrangement and what is going to occur with regard to the indebtedness post-confirmation as a result of that plan.

As the discussion above also indicates, regardless of the posture of the parties prior to confirmation, the plan controls the post-confirmation posture. If creditors want to enforce their rights under the plan post-confirmation, they are relegated to their rights outside of the bankruptcy proceeding. They must proceed outside of the bankruptcy court to force the debtor to perform according to the contractual arrangement between the reorganized debtor and the creditor under the plan unless the plan provides for continuing jurisdiction of the bankruptcy court to hear such matters. Most plans do not. Should the debtor reach its goal in the Chapter 11 proceeding of reorganizing and obtaining confirmation of the proposed plan, the creditors are bound by the terms of that plan.

Chapter 11 is a useful tool which has wide ramifications that must be understood by those members of the commercial bar representing the debtor's side as well as the creditors. The Code itself contains certain safeguards for creditor's. It is incumbent upon the creditors and their attorneys to utilize these safeguards, and this requires an understanding of the entire Chapter 11 process.

---

bankruptcy is entitled to an order reflecting this disposition of Elco's claim in the debtor's ensuing bankruptcy. Submit such an order.

In re Stratton, Ltd., 12 Bankr. at 474-75.

ADDENDUM

UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF INDIANA
INDIANAPOLIS DIVISION

In re
JERICO, INCORPORATED, NO. IP
Debtor.

PLAN OF REORGANIZATION

Definitions

The following terms, when used in the Plan, shall, unless the context otherwise requires, have the following meanings, respectively:

Debtor: Jerico Incorporated, an Indiana corporation.

Chapter 11: Chapter 11 of the Bankruptcy Code.

Court: The United States Bankruptcy Court for the Southern District of Indiana, Indianapolis Division, acting in this case.

Plan: This Plan of Reorganization.

Creditors' Committee: That Creditors' Committee appointed by the court herein.

Confirmation of the Plan: The entry by this Court of an order confirming the Plan in accordance with Chapter 11.

Consummation of Plan: The accomplishment of all things contained or provided for in this Plan, and the entry of an order of consummation finally dismissing the case.

Effective Date: That date on which the order confirming the Plan becomes final and nonappealable.

Joint Venture: The relationship of Gannon Oil Co., Inc. and ABC, Inc.

Guaranteed: The unconditional joint and several guarantee of Gannon Oil Co., Inc. and ABC, Inc.

Reorganized Debtor: The status of the Debtor after confirmation of the Plan.

The official Creditors Committee and Terry Shake, Trustee, both being parties in interest propose the following plan of arrangement.

Article I

Classification of Claims and Interests

The claims and interests shall be classified as follows:

Class 1 Unsecured claims to the extent that such claims are approved and allowed by the Court, including unsecured claims arising from the rejection of all executory contracts not assumed under this Plan.

Class 2 Unsecured claims of The Northfield Corporation and Bank of Indiana to the extent that such claim is approved and allowed by the Court.

Class 3 The claim of Gannon Oil Co., Inc. to the extent that such claim is approved and allowed by the Court.

Class 4 Secured claims as such claims existed on the date of the filing of the petition for relief under Chapter 11 of the Bankruptcy Code.

Class 5 Claim of the Bloomington Bank.

Article II

Claims and Interests not Impaired Under the Plan

There are no class of claims or interests which are not impaired under this Plan.

Article III

Treatment of Classes that are Impaired Under the Plan

Each class of claim shall be treated as follows:

Class 1 Each member of this class shall have the option of the selection of one of the following alternatives:

A. A sum equivalent to fifty-six percent (56%) of the allowed claim. This payment shall be made in one cash payment at the time of the effective date of the Plan.

B. A sum equivalent to seventy-eight percent (78%) of the allowed claim. This payment shall be evidenced by an installment promissory note issued on the effective date of confirmation of the Plan by the Reorganized Debtor, payable in

thirty-six (36) equal monthly installments without interest commencing upon the first day of the month following the effective date of the Plan. The first twenty-four (24) monthly payments will be guaranteed by each member of the joint venture.

C. Payment of one hundred percent (100%) of the allowed claim by the Court. This payment shall be evidenced by an installment promissory note issued on the effective date of confirmation of the Plan by the Reorganized Debtor, the final payment being one hundred twenty (120) months from the effective date of the Plan. The note shall be without interest. Monthly installment payments shall commence twelve (12) months following the effective date of the Plan and shall continue in one hundred eight (108) equal installments thereafter. Each payee of the note shall have the option at the end of ninety-six (96) months to demand payment on the entire note balance. The first thirty-six (36) monthly payments will be guaranteed by each member of the joint venture.

Class 2 Payment of one hundred percent (100%) of the allowed claim by the Court. This payment shall be evidenced by an installment promissory note issued on the effective date of the confirmation of the Plan by the Reorganized Debtor, the final payment being due one hundred twenty (120) months from the effective date of the Plan. The note shall be without interest. Monthly installment payments shall commence twelve (12) months following the effective date of the Plan and shall continue in one hundred eight (108) equal installments thereafter. The payee of the note shall have the option at the end of ninety-six (96) months to demand payment on the entire note balance. The first thirty-six (36) monthly payments will be guaranteed by each member of the joint venture.

Class 3 In the same manner as Class 1 claims.

Class 4 The debt shall be paid pursuant to the terms of the debt instrument except the interest rate in each instrument shall be a fixed simple interest rate of ten percent (10%) per annum. Past due

installments existing on the effective date of the Plan will be cured first by extending the term of each debt by two months. Then the balance of any cure shall be paid at the effective date of the Plan. The holder of each claim will retain a lien on the property securing said debt.

Class 5 The debt shall be paid pursuant to the terms of the debt instrument except the interest rate in each instrument shall be a fixed simple interest rate of ten percent (10%) per annum. Past due installments existing on the effective date of the Plan will be cured first by extending the term of each debt by two months. Then the balance of any cure shall be paid at the effective date of the Plan. The holder of each claim will retain a lien on the property securing said debt. The claim shall be guaranteed to the extent of the portion previously guaranteed to the Small Business Administration.

Article IV

Provisions for Acceptance or Rejection of Executory Real Estate Leases

A. The debtor will assume pursuant to § 365 of the Bankruptcy Code, each of the executory real estate leases set forth in Exhibit A attached hereto and made a part hereof.

B. The debtor shall assume, pursuant to § 365 of the Bankruptcy Code, the executory franchisee contracts discussed in Exhibit B attached hereto and made a part hereof.

C. The executory real estate leases set forth in Exhibit C [not attached for purposes of this Article] shall, pursuant to § 365 of the Bankruptcy Code, upon notice and hearing to any person, firm or corporation claiming an interest, be rejected and at such hearing the Court shall fix the dollar amount of damages, if any, and such person, firm or corporation shall become a Class 1 creditor.

D. The executor real estate leases set forth in Exhibit D [not attached for purposes of this Article] shall be conditionally assumed by the Debtor until August 31, 1981 pursuant to the terms of the lease. The Reorganized Debtor would have the right to either affirm or reject the executory lease by giving the lessor notice. If the Reorganized Debtor elects to reject the lease, the landlord would become a Class 1 creditor.

E. The Debtor shall assume all executory contracts with The Northfield Corporation which will be paid pursuant to the terms of the Plan.

F. Any and all other executory contracts of the Debtor not specifically set forth herein are hereby rejected and treated as Class 1 claims.

Article V

Means for Execution of the Plan

Execution of this Plan upon its effective date shall be accomplished pursuant to an agreement entered into by and between the Joint Venture, the Trustee, and Official Creditors' Committee executed June 17, 1980. The Joint Venture, under separate agreement with the individual shareholders, will purchase the outstanding shares of the Debtor's stock prior to the effective date of the Plan.

Article VI

Provisions for Priority Claims

Each claim of the kind specified in sections 507(a)(1), 507(a)(2), 507(a)(3), 507(a)(4), and 507(a)(5) shall be paid on the effective date of the Plan cash equal to the allowed amount of such claim unless said claims are waived or payments otherwise agreed to. Each claim of the kind specified in Section 507(a)(6) shall be paid in full when due.

Article VII

General Provisions

Until the case is closed, the Court shall retain jurisdiction to insure that the purpose and intent of this Plan are carried out. The Court shall retain jurisdiction to hear and determine all claims against the Debtor and to enforce all causes of action which may exist on behalf of the Debtor. Nothing herein contained shall prevent the Reorganized Debtor from taking such action as may be necessary in the enforcement of any cause of action which may exist on behalf of the Debtor and which may not have been enforced or prosecuted by the Trustee.

DATED: July 15, 1980 ________________.

OFFICIAL CREDITORS' COMMITTEE

by________________________________

ROBERT COOPER
One of Counsel

TERRY SHAKE, Trustee for
JERICO, INCORPORATED

by____________________________
EVERETT LINDSAY
One of Counsel

Acceptance

Gannon Oil Co., Inc. and ABC, Inc., have entered into an agreement on or about June 17, 1980 with Terry Shake, Trustee, and the Official Creditors, Committee, hereby acknowledge the Plan of Reorganization contained herein and accept its terms pursuant to said Agreement.

DATED this 15 day of July, 1980.

GANNON OIL CO., INC.

by____________________________

ABC, INC.

by____________________________

UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF INDIANA
INDIANAPOLIS DIVISION

IN RE:
JERICO INCORPORATED, NO.
Debtor.

DISCLOSURE STATEMENT

I

Introduction

Terry Shake, Trustee of Jerico, Incorporated, the debtor, and the Official Creditors' Committee of Jerico, Incorporated provides this Disclosure Statement to all of the known creditors of Jerico, Incorporated in order to disclose that information deemed by the Trustee and the Official Creditors' Committee to be material, important, and necessary for the creditors of Jerico, Incorporated to arrive at a reasonably informed decision in exercising their right to vote for acceptance of the Plan of Reorganization (hereinafter "the Plan") presently on file with the Bankruptcy Court. A copy of the Plan accompanies this Statement.

The Court has set August 15, 1980, at 10:00 a.m. for a first meeting of creditors and at 11:00 a.m. for a hearing on the acceptance of the Plan of Reorganization. Creditors may vote on the Plan by filling out and mailing the accompanying Acceptance Form to the Bankruptcy Court or may attend such hearing and present the Acceptance in person at that time. As a creditor, your acceptance is important. In order for the Plan to be deemed accepted, creditors that hold at least two-thirds in amount and more than one-half in number of the allowed claims of Class 1 and 5 must vote for the Plan.

NO REPRESENTATIONS CONCERNING THE DEBTOR (PARTICULARLY AS TO HIS FUTURE BUSINESS OPERATIONS, VALUE OF PROPERTY, OR THE VALUE OF ANY PROMISSORY NOTES TO BE ISSUED UNDER THE PLAN) ARE AUTHORIZED BY THE TRUSTEE OR THE OFFICIAL CREDITORS' COMMITTEE OTHER THAN AS SET FORTH IN THIS STATEMENT. ANY REPRESENTATIONS OR INDUCEMENTS MADE TO SECURE YOUR ACCEPTANCE WHICH ARE OTHER THAN AS CONTAINED IN THIS STATEMENT SHOULD NOT BE RELIED UPON BY YOU IN ARRIVING AT YOUR DECISION, AND SUCH ADDITIONAL REPRESENTATIONS AND INDUCEMENTS SHOULD BE REPORTED TO COUNSEL FOR THE TRUSTEE WHO IN TURN SHALL DELIVER SUCH INFORMATION TO THE BANK-

RUPTCY COURT FOR SUCH ACTION AS MAY BE DEEMED APPROPRIATE.

THE INFORMATION CONTAINED HEREIN HAS NOT BEEN SUBJECT TO A CERTIFIED AUDIT. THE RECORDS KEPT BY THE DEBTOR AND TRUSTEE ARE DEPENDENT UPON AN ACCOUNTING PERFORMED BY OTHERS BEYOND THE CONTROL OF THE TRUSTEE OR THE OFFICIAL CREDITORS' COMMITTEE. FOR THE FOREGOING REASONS, AS WELL AS BECAUSE OF THE GREAT COMPLEXITY OF THE DEBTOR'S FINANCIAL MATTERS, THE TRUSTEE AND THE OFFICIAL CREDITORS' COMMITTEE IS UNABLE TO WARRANT OR REPRESENT THAT THE INFORMATION CONTAINED HEREIN IS WITHOUT ANY INACCURACY, ALTHOUGH GREAT EFFORT HAS BEEN MADE TO BE ACCURATE.

II

The Plan of Reorganization

The Plan is based upon the belief of the Trustee and the Official Creditors' Committee that the present forced liquidation value of the principal assets of the debtor is so small as to offer the potential of only a minimal recovery to general unsecured creditors. The Trustee and the Official Creditors' Committee believe it is possible and in the best interest of all creditors to allow for the continued operation of the debtor as a reorganized debtor, pursuant to which, the reorganized debtor will make available to general unsecured creditors three alternatives for payment of a percentage of their claim and will allow for the normal retirement of secured indebtedness over a negotiated period of time at a negotiated rate of interest all of which are to be paid out of the future operations of the debtor-in-possession and some of which payments are to be guaranteed as hereinafter more specifically set forth. It is believed that if the debtor were liquidate, the amount realized by unsecured creditors would be minimal in relation to what is being proposed to the various classes of creditors pursuant to the Plan of Reorganization which accompanies this statement.

The Plan provides in Article I for the classification of claims and interests. The claims and interests are classified into five separate classes.

Class I claims are unsecured claims approved and allowed by the Court. Claims under this class are generally unsecured creditors who are either purveyors, suppliers of merchandise, or suppliers of services and includes unsecured claims arising from the rejection of all executory contracts not specifically assumed under the Plan. Each member of Class I, shall have the option of selecting one of the following alternatives:

(a) The sum equivalent to 56% of the allowed claim. This payment of 56% shall be made in one cash payment at the time of confirmation of the Plan. Funds for this payment will be made available by funds on hand of the debtor and by an infusion of capital of a joint venture composed of Gannon Oil Co., Inc., and ABC, Inc., the entities which are purchasing the stock of the debtor corporation.

(b) A sum equivalent to 78% of the allowed claim of each unsecured creditor. This payment shall be in the form of an installment promissory note (see Exhibit "A") issued on the effective date of confirmation of the Plan by the reorganized debtor and payable in 36 equal monthly installments without interest, commencing on the 1st date of the month following the effective date of the Plan. The first 24 monthly payments will be guaranteed by each member of the joint venture.

(c) Payment of 100% of the allowed claim by the Court. This payment shall be in the form of an installment promissory note (see Exhibit "B") issued on the effective date of confirmation of the Plan by the reorganized debtor with the final payment being 120 months from the effective date of the Plan. The note shall be without interest. Monthly installment payments shall commence 12 months following the 1st date of the month following the effective date of the Plan and shall continue in 108 equal installments thereafter. Each payee of the note shall have the option at the end of 96 months to demand payment on the entire note balance. The first 36 monthly payments will be guaranteed by each member of the joint venture.

The three methods of payment to unsecured creditors in Class I offer an alternative to each member of that class to choose the payment program which he wishes. The acceptance by the creditor of an immediate payment of 56 cents on the dollar as of the effective date of the Plan would provide no risk to any member in Class I. The acceptance of alternative (b) or (c), providing for 78% of the allowed claim over a period of 36 months or 100% of the allowed claim over a period of 120 months, provides a certain risk to an accepting unsecured creditor in Class I which will be set forth under the heading *Special Risk Factors*. A copy of the form of the note to be provided Class I creditors who choose alternative (b) or (c) is attached.

Class I further provides for unsecured claims arising from the rejection of certain executory contracts for the lease of real estate to the extent that such claim is approved and allowed by the Court. The debtor owns no real property and leases all locations where its

stores are located. The Plan sets forth in Article IV the leases which will be assumed by the reorganized debtor and the leases that will be rejected by the debtor. Article III Class I provides for the method of payment to those lessors holding leases which are rejecting by the debtor. Under § 502 of the United States Bankruptcy Code, the lessor has a claim for damages resulting from a termination of the lease of real property to the extent of the rent reserved by such lease, without acceleration, for the greater of one year or fifteen percent, not to exceed three years of the remaining term of such lease, following the earlier of the date of the filing of the petition, the date on which such lessor repossessed, or the date on which the lessee surrendered the leased property, plus any unpaid rent due under such lease, without acceleration, on the earlier of such dates.

In addition to those executory contracts which are to be assumed by the reorganized debtor as set forth in Exhibit "A" to the Plan of Reorganization, and in addition to the executory real estate leases as set forth in Exhibit "C" which are to be rejected by the debtor, Article IV subparagraph (d) provides for certain executory real estate leases which are set forth in Exhibit "D" to the Plan of Reorganization and are to be conditionally assumed by the reorganized debtor until August 31, 1981, pursuant to the terms of the lease. At the termination of that period, the reorganized debtor would have the right to either affirm or reject the executory lease. If the reorganized debtor elects to reject the lease, the landlord would become a Class I creditor for its allowed claim in these proceedings. Article IV further sets forth the provision that the debtor shall assume, pursuant to § 365 of the United States Bankruptcy Code, the executory franchise contracts set forth in Exhibit "B" to the Plan of Reorganization. ANY AND ALL OTHER EXECUTORY CONTRACTS OF THE DEBTOR NOT SPECIFICALLY SET FORTH IN ARTICLE IV ARE REJECTED PURSUANT TO THE PLAN OF REORGANIZATION. CLAIMS ARISING THEREFROM SHALL BE TREATED AS CLASS I CREDITORS.

The Plan also provides for the classification of a separate class of creditors composed of the Northfield Corporation and the Bank of Indiana. This separate classification is set forth by virtue of the fact that the Northfield Corporation is not only a general unsecured creditor as a purveyor of merchandise but is also a licensor of the debtor and has guaranteed certain obligations of the debtor, including but not limited to, the obligation that is due and owing to the Bank of Indiana and any obligations for attorney fees arising out of that certain lawsuit entitled *The Northfield Corporation, plaintiff—counter-defendant v. Super Markets, Inc., defendant—counter-plaintiffs v. Jerico, Inc., counter-defendant*, pending in the United

States District Court for the Southern District of Indiana, Indianapolis Division, which is presently on appeal to the United States Court of Appeals for the Seventh Circuit. The obligation due and owing to the Northfield Corporation, licensor and purveyor of goods to the debtor, is in the approximate amount of $395,456.00, together with an indebtedness due from debtor to the Bank of Indiana guaranteed by Northfield in the approximate amount of $216,666.00, together with additional amounts estimated to be due Northfield in the amount of $40,000.00, for a total amount due and owing to Northfield Corporation on all obligations in the sum of $652,122.00. The Plan of Arrangement, as proposed, provides for the payment to creditors of Class II of 100% on the dollar of the allowed claim by the Court. The payment of 100 cents on the dollar is the same alternative offered to creditors of Class I, in that the payment of 100 cents on the dollar shall be evidenced by an installment promissory note issued on the effective date of confirmation of the Plan by the reorganized debtor, the final payment being dated 120 months from the effective date of the Plan. The note issued by the reorganized debtor shall be without interest. Monthly installment payments shall commence twelve months following confirmation and shall continue in 108 equal installments thereafter. The payee of the note shall have the option at the end of ninety-six months to demand payment of the entire note balance. The first thirty-six monthly payments will be guaranteed by the joint venture of Gannon Oil Co., Inc. and ABC, Inc. It is important to note that the treatment of Class II creditors is the sffered to Class I creditors.

Class III of the Plan is Gannon Oil Co., Inc., since it is a purchaser of the stock of Jerico, Incorporated, and will be executing certain guarantees as the creditors in Class I may choose. Treatment afforded to Gannon Oil Co., Inc. is the same treatment that is being afforded to Class I creditors.

The Plan further provides for classification of secured creditors in Class IV. These creditors are primarily creditors who hold security on certain equipment of the debtor and include the Bank and Trust, Columbus, Indiana; the National Bank and Trust Company, Indianapolis, Indiana; the Bank and Trust, Noblesville, Indiana; the National Bank, Danville, Indiana; the Bank & Trust, Little Rock, Arkansas; and the Bank and Trust New Albany, Indiana. The debt evidenced by creditors holding claims in Class IV shall be paid pursuant to the terms of the debt instrument except that the interest rate in each instrument shall be a fixed simple interest rate of 10% per annum. Past due installments existing on the effective date of the Plan will be cured first by extending the term of each debt by two months. Then the balance of any cure shall be paid at the effective date of the Plan. The holder of each claim will retain a lien on the property securing said debt.

The remaining classification of claims is Class V which provides for a classification of the claim of the Bloomington Bank. The Bloomington Bank is set forth in a separate class by virtue of its setting off of certain obligations due and owing to the Bloomington Bank in the sum of $173,884.92 within ninety days prior to bankruptcy. The Trustee and the Official Creditors' Committee has taken the position that said set off is a preference. Notwithstanding that fact, the Plan proposes to treat the Bloomington Bank in Class V upon repayment by the Bloomington Bank to the Trustee of the sums set off with repayment of said debt to the Bloomington Bank pursuant to the terms of the debt instrument with the bank, except that the interest rate in said instrument shall be a fixed simple interest rate of 10% per annum. Past due installments existing on the effective date of the Plan will be cured first by extending the terms of the debt by two months. The balance of any cure shall be paid at the effective date of the Plan. The Bloomington Bank will retain a lien on the property securing said debt, and the debt shall be guaranteed by each member of the joint venture for the SBA portion previously guaranteed.

THE FOREGOING IS A BRIEF SUMMARY OF THE PLAN AND SHOULD NOT BE RELIED ON FOR VOTING PURPOSES. CREDITORS ARE URGED TO READ THE PLAN IN FULL. CREDITORS ARE FURTHER URGED TO CONSULT WITH COUNSEL OR WITH EACH OTHER IN ORDER TO FULLY UNDERSTAND THE PLAN. THE PLAN IS COMPLEX INASMUCH AS IT REPRESENTS A PROPOSED LEGALLY BINDING AGREEMENT BY THE TRUSTEE, DEBTOR, AND REORGANIZED DEBTOR, AND AN INTELLIGENT JUDGMENT CONCERNING SUCH PLAN CANNOT BE MADE WITHOUT UNDERSTANDING IT.

III

Financial Information Respecting the Reorganized Debtor

The financial information hereinafter presented is to be considered in the context of the debtor's primary business activity of operating convenience food stores and making sales of gasoline. As previously stated, the debtor owns no real property. All real property utilized by the debtor is on lease, and there may or may not be any equity value in any of the leases. The machinery and equipment used in the business has been used for a period of time, and it is estimated that the depreciated value of the equipment on the books of the corporation is not its true liquidation value. Its true liquidation value in the estimates of the Trustee and the Official Creditors' Committee would be much less than the depreciated book value and

also much less than any amount owing to secured creditors on said equipment. The debtor did not own at any time any gasoline pumps or any gasoline storage tanks. That equipment was at all times owned by Gannon Oil Co., Inc. A further question arises as to whether or not gasoline in storage tanks on various premises of the debtor was in fact inventory of the debtor or belonged to Gannon Oil Co., Inc. under a consignment agreement. The Trustee and Official Credi-tors' Committee have taken the position that the gasoline on hand at any given date was an asset of the debtor. Gannon Oil Co., Inc. has taken the position that it was an asset of Gannon Oil Co., Inc. The treatment of Gannon Oil Co., Inc. as an unsecured creditor pursuant to the Plan of Arrangement puts that issue at rest. However, the value of the remaining machinery and equipment of the debtor, in your Trustee's opinion, is insignificant to the amount due and owing on the equipment and has no relationship to the depreciated book value of said equipment. With the exception of inventory, therefore, all of debtor's assets are encumbered by holders of prior secured claims, and accordingly, the amount of both secured claims and unsecured claims is relevant.

A statement of assets and liabilities of the debtor as of the date of the filing of the petition under Chapter 11 of the United States Bankruptcy Code on May 28, 1980, has been filed with the Bankruptcy Court as of July 9, 1980. The schedule and statement of assets and liabilities should be inspected by all interests parties. The Trustee has estimated the total debts of the debtor to be as follows:

Taxes owing to other than taxing authorities	$ 20,000.00
Secured claims	712,848.59
Unsecured claims without priority	1,762,818.56
Total debts of debtor corporation	2,495,667.15

These are estimates only by the Trustee, and there has been no independent verification from creditors. IT IS IMPORTANT TO NOTE THAT ALL DEBTS OF THE DEBTOR WERE LISTED BY THE TRUSTEE AS BEING DISPUTED, CONTINGENT, AND UNLIQUIDATED BY VIRTUE OF THE FACT THAT THE TRUSTEE COULD NOT INDEPENDENTLY VERIFY AND HAS NOT HAD SUFFICIENT TIME TO INDEPENDENTLY VERIFY THAT THE TOTAL DEBTS AS SET FORTH ON THE SCHEDULES AND STATEMENTS OF AFFAIRS ARE ACCURATE. SINCE THE TRUSTEE HAS LISTED ALL DEBTS AS DISPUTED, CONTINGENT, AND UNLIQUIDATED, FOR ANY CREDITOR TO SHARE IN A DISTRIBUTION IN THE ESTATE AND RECEIVE A DIVIDEND FROM THE ESTATE, SAID CREDITOR *MUST* FILE A PROOF OF CLAIM IN THESE PROCEEDINGS. It is further noted by the Trustee and the Official Creditors' Committee that the amount of debts of the corporation may be increased by virtue of certain lawsuits pending, a portion of which have been removed to the Bankruptcy Court, and a portion of which are on appeal. In addition, the debts as scheduled by the Trustee do not include any amounts that would be due to lessors under rejection of executory lease contracts. Those amounts arising by the rejection of executory contracts in Arti-

cle IV (c), and those amounts arising by those executory contracts which may be rejected in one year under Article IV (d) are not included in the total debt listing of the Trustee.

The schedules and statement of affairs further reflect the property as listed by the Trustee as belonging to the debtor. That property may be summarized as follows and as appearing as of May 28, 1980, the date of the filing of the Chapter 11 petition:

Cash on hand	$ 393,000.00
Depreciated book value of machinery, equipment, and supplies used in business	970,000.00
Inventory on hand	310,000.00
Depreciated book value of patents and other general intangibles	55,000.00
Other liquidated debts due the debtor	130,000.00
Total property of the debtor	$1,858,000.00

The cash on hand of the debtor oscillates, depending upon payment for gasoline sales made, payments to suppliers, and receipts for merchandise sold. The value of depreciated machinery, equipment, and other supplies used in the business is a depreciated book value, and it is the opinion of the Trustee and the Official Creditors' Committee that the listed value is greater than the liquidation value of said equipment, machinery, and supplies used in business, and in addition, the actual liquidation value of said machinery, equipment, and supplies used in business is less than the amount owed to secured creditors. It has been estimated by the Trustee that the true liquidation value of all machinery, equipment, and supplies used in the business owned by the debtor is the sum of $275,000.00, not including pumps and storage tanks in the ground used for gasoline which are claimed as owned by Gannon Oil Co., Inc. The inventory value in the sum of $310,000.00 is exclusive of gasoline and has fluctuated since the date of the filing of the petition under Chapter 11 of the United States Bankruptcy Code. The patent and other general intangibles in the sum of $55,000.00 is the original value of the license owned by the debtor for the operation of Super Markets, Inc. and its value cannot be estimated by the Trustee. Other liquidated debts due and owing to the debtor in the sum of $130,000.00 represent accounts receivable and notes receivable of questionable value.

It is deemed relevant by the Trustee and the Official Creditors' Committee that the total estimated liquidation value of machinery, equipment, and supplies used in business is approximately $275,000.00, taken in light of the total indebtedness due and owing on said equipment and machinery in the sum of $712,848.59.

The following is the Trustee's best estimates of the secured creditors holding security as set forth above:

The Bloomington Bank security in store equipment	$173,884.92
The Bank and Trust, Columbus, Indiana security in store equipment	46,644.66
The National Bank and Trust Company security in store equipment	166,666.70

The Bank and Trust, Noblesville, Indiana security in store equipment	28,679.04
The National Bank, Danville, Indiana security in store equipment	84,503.00
The Bank and Trust, Little Rock, Arkansas security in store equipment	92,532.00
The Bank and Trust, New Albany, Indiana security in store equipment	123,551.58
Total secured indebtedness	$716,461.90

The total amount due and owing to tax creditors are personal property taxes for assessments made March of 1979 and 1980 payable in May and November, 1980, in Monroe County, Marion County, Bartholomew County, Hamilton County, Madison County, Hendricks County, Hancock County, Floyd County and Clark County in the total sum of $20,000.00.

According to the best estimates of your Trustee, the amount of claims held by general unsecured trade creditors who would be affected by the treatment of Class I creditors is in the sum of approximately $700,000.00. Amounts due Northfield and the Bank of Indiana approximate $652,000.00, and the debt due to Gannon Oil Co., Inc. approximates $191,000.00. Additional claims included in the total unsecured claims without priority represent contingent lawsuits and other claims.

It is estimated that the amount of the allowed claims of lessors on the rejection of executory contracts is in the sum of $89,493.00. In addition, certain executory contracts which are set forth in Exhibit "D" to the Plan of Arrangement will be conditionally assumed by the reorganized debtor for a period of one year, pursuant to the terms of the lease, and at the termination of one year from the effective date of the Plan, the reorganized debtor would have the right to either affirm or reject the executory leases. If the reorganized debtor elects to reject the leases, the estimated amount of unsecured liability on those leases is in the sum of $138,915.00.

To your Trustee's knowledge, and the knowledge of the Official Creditors' Committee, the debtor owns no stock in any other entity but does hold a note in the sum of $25,000.00 from Uptown Realty Corporation secured by property located at 21st and Vine, Indianapolis, Indiana.

The Plan provides that the joint venture of Gannon Oil Co., Inc. and ABC will purchase the issued and outstanding stock held by officers of Jerico Corporation for the sum of $5,000.00 plus forgiveness of a $25,000.00 note due from Steven Harold to the debtor which the joint venture deems uncollectible. Gannon Oil Co., Inc., and ABC, Inc., have been operating the debtor corporation under a manage-

ment agremeent with the Trustee since June 17, 1980. The continued operation by Gannon Oil Co., Inc., and ABC, Inc., will allow for a continued and uninterrupted chain of management through the new reorganized debtor.

Said stock purchase will be consummated subsequent to acceptance of the Plan of Arrangement and prior to the confirmation of said Plan.

All priority claims will be paid in full upon consummated of the Plan of Arrangement unless waived or otherwise agreed to. Those claims include all claims set forth in sections 507(a)(1), 507(a)(2), 507(a)(3), 507(a)(4), and 507(a)(5). More specifically, those claims include administrative claims of the Trustee, the Trustee's counsel, the Official Creditors' Committee, and attorney for the debtor all of which shall be paid in full upon confirmation, and all expenses of doing business, including payments for merchandise received, shall be paid according to terms of payment, or if administrative claims are past due as of that time, they shall be paid in full. Claims of all secured creditors shall be paid pursuant to the provisions for payment of secured creditors, and the payments of all obligations under leases being assumed by the reorganized debtor shall be cured and paid in full upon confirmation. In addition, each claim of the kind specified in section 507(a)(6), tax claims of the debtor, shall be paid in full when due.

To accomplish the payments of all funds as above set forth, including provisions for treatment of classes, Gannon Oil Co., Inc., and ABC, Inc., shall fund the proposed Plan of Reorganization for the reorganized debtor and shall provide the monies necessary for payment to classes calling for payment upon confirmation and for the provisions for payment of priority claims.

IV

Special Risk Factors

Certain substantial risk factors are inherent in most securities issued pursuant to a Plan of Reorganization in a Chapter 11 case. If such plans are accepted, it is usually because they represent a greater hope for return than the dividend in a liquidating Chapter 7 case. ALL OF THE RISK FACTORS INHERENT IN SECURITIES ISSUED PURSUANT TO A PLAN OR REORGANIZATION ARE PRESENT IN THE PROMISSORY NOTES PROPOSED TO BE ISSUED IN THIS CASE SHOULD CREDITORS IN CLASS I CHOOSE TO ACCEPT PROMISSORY NOTES AND IN THE OTHER CLASSES WHERE PROMISSORY NOTES ARE ISSUED. While creditors in Class I, if they so choose, and creditors in Class II, III, IV and V will be accepting notes of the reorganized debtor,

and while there is a guarantee as set forth in Article III of certain portions of those notes by Gannon Oil Co., Inc. and ABC, those creditors accepting notes should realize that outside of the viability of Gannon Oil Co., Inc., and ABC, there is no guarantee that said notes will be paid in full when due. Based upon the April 30, 1980, financial statements supplied by Gannon Oil Co., Inc., and ABC, Inc., which are on file in the offices of the attorney for the Trustee and attorney for the Official Creditors' Committee, the combined unaudited net worth of both companies is approximately $1,500,000.00. These financial statements may be reviewed at either of the above offices by any creditor during normal business hours. The Trustee and the Official Creditors' Committee make no representation or warranty of payment in full of said notes when due.

It is expected that should any Class I creditor choose to accept treatment under subparagraph (b) or (c) of Article III Class I and receive a promissory note that no market will exist for said notes issued under the Plan and realization upon them must await distributions pursuant to the terms of said note, if any, from the reorganized debtor. The notes as issued under the Plan are exempt from registration under the Securities Act of 1933 and State or local laws to the extent provided in 11 U.S.C. § 1145 (Supp. IV 1980).

DATED at Indianapolis, Indiana, this 15 day of July, 1980.

TERRY SHAKE, TRUSTEE FOR
JERICO, INCORPORATED

By______________________________
Everett Lindsay, One of Counsel

OFFICIAL CREDITORS' COMMITTEE OF
JERICO, INCORPORATED

By______________________________
Robert Cooper, One of Counsel

PROMISSORY NOTE AND LIMITED WARRANTY

NOTE

$____________________ Date: August____, 1980

For value received the undersigned promises to pay to the order of ____________________________ the total sum of__________ ____________________________Dollars ($___________), at________ _______________________ or at such other place as the holder hereof may direct in writing. Payment shall be in 36 equal monthly installments commencing on September 1, 1980 and each month thereafter. No interest shall be payable on any amount due hereunder.

In the event of any default in payment not cured within 15 days after receipt by maker of written notice of such default by certified mail addressed to maker at______________________________ ____________________________, then the holder of this note shall have the right to declare the entire remaining balance immediately due and payable without further presentment, protest, notice of protest or dishonor. After default, upon acceleration, the holder shall be entitled to recover attorney fees and costs in collection of this note, all without relief from valuation and appraisement laws.

No delay or omission on the part of the holder hereof in the exercise of any right or remedy shall operate as a waiver of such right or remedy and no single or partial exercise of any right or remedy by the holder shall preclude further exercise of any other right or remedy.

JERICO, INC.

By______________________________
President

LIMITED GUARANTY

Date: August____, 1980

In order to induce the payee of the above note to accept same, the undersigned, jointly and severally, absolutely guaranty the full and prompt payment of every indebtedness due together with reasonable attorney's fees and costs of collection to the extent allowed by the note.

Provided, however, the liability of the undersigned pursuant to this Guaranty shall be limited only to the making of the first 24 installments due upon the note and such guaranty shall not extend to any other installments. The liability of the undersigned shall arise upon acceleration of the note by the holder when effected in accordance with the terms contained in the note and payment of any remaining guaranteed amount shall be made upon demand. Such liability shall not be affected by any settlement, compromise, extension, or variation of the terms of the note.

The undersigned hereby expressly waive the following: (a) notice of (and acknowledge due notice of) acceptance of this Guaranty by payee; (b) protests, demands, pursuit of collection, and notices thereof; (c) notices of nonpayment and nonperformance and amount of indebtedness outstanding at any time; and (d) the right to remove any legal action from the Court originally acquiring jurisdiction. This agreement shall, without further consent of or notice to the undersigned, pass to, and may be relied upon and enforced by, any successor or assignee of payee.

GANNON OIL CO., INC.

By__________________________Guarantor

ABC, INC.

By__________________________Guarantor

PROMISSORY NOTE AND LIMITED GUARANTY

NOTE

$____________________ Date: August____, 1980

For value received the undersigned promises to pay to the order of ____________________________ the total sum of________ ________________________Dollars ($__________), at_______ _____________________ or at such other place as the holder hereof may direct in writing. Payment shall be in 108 equal monthly installments commencing on September 1, 1980 and each month thereafter. No interest shall be payable on any amount due hereunder. The holder shall have the right to demand payment in full of the remaining balance at any time after September 1, 1988.

In the event of any default in payment not cured within 15 days after receipt by maker of written notice of such default by certified mail addressed to maker at_______________________________ __________________________, then the holder of this note shall have the right to declare the entire remaining balance immediately due and payable without further presentment, protest, notice of protest or dishonor. After default, upon acceleration, the holder shall be entitled to recover attorney fees and costs in collection of this note, all without relief from valuation and appraisement laws.

No delay or omission on the part of the holder hereof in the exercise of any right or remedy shall operate as a waiver of such right or remedy and no single or partial exercise of any right or remedy by the holder shall preclude further exercise of any other right or remedy.

JERICO, INC.

By______________________________
President

LIMITED GUARANTY

Date: August____, 1980

In order to induce the payee of the above note to accept same, the undersigned, jointly and severally, absolutely guaranty the full and prompt payment of every indebtedness due together with reasonable attorney's fees and costs of collection to the extent allowed by the note.

Provided, however, the liability of the undersigned pursuant to this Guaranty shall be limited only to the making of the first 36 installments due upon the note and such guaranty shall not extend to any other installments. The liability of the undersigned shall arise upon acceleration of the note by the holder when effected in accordance with the terms contained in the note and payment of any remaining guaranteed amount shall be made upon demand. Such liability shall not be affected by any settlement, compromise, extension, or variation of the terms of the note.

The undersigned hereby expressly waive the following: (a) notice of (and acknowledge due notice of) acceptance of this Guaranty by payee; (b) protests, demands, pursuit of collection, and notices thereof; (c) notices of nonpayment and nonperformance and amount of indebtedness outstanding at any time; and (d) the right to remove any legal action from the Court originally acquiring jurisdiction. This agreement shall, without further consent of or notice to the undersigned, pass to, and may be relied upon and enforced by, any successor or assignee of payee.

GANNON OIL CO., INC.

By__________________________Guarantor

ABC, INC.

By__________________________Guarantor

IN THE MATTER OF:) CASE NO. ____________
)
) INTERIM FINANCIAL REPORT NO. __
)
) ________ THROUGH ________
________)
PETITION FILED: ____________

(ITEMS 1 THROUGH 16 MUST BE ANSWERED)
(USE "NONE" OR "N/A" WHERE APPROPRIATE)

SUMMARY OF CASH TRANSACTIONS

1. Cash and Bank Balances at beginning of Current Reporting Period. $ ________
2. Receipts during Current Reporting Period:
   A. Cash Sales (ordinary courses of business) ________
   B. Collection of Pre-Chapter 11 Receivables (Net of Discounts) ________
   C. Collection of Post-Chapter 11 Receivables ________
   D. Other Cash Receipts (attach schedule itemizing receipts-See Form 2D attached) ________
   TOTAL RECEIPTS (2A through 2D) ________
3. Cash Disbursements during Reporting Period (exclude transfers between bank accounts for payrolls, taxes, etc.)
   A. For ordinary operations:
   1. Net payroll other than officers, stockholders and directors. ________
   2. Net payroll, officers, stockholders and directors (attach list of salaries of officers, directors & management personnel requested only for initial report unless there are changes in salaries or personnel). ________
   3. Payroll taxes disbursed to taxing authorities. ________
   4. Other taxes disbursed to taxing authorities. ________
   5. Utilities. ________
   6. Insurance premiums (See #15) ________
   7. Rent (premises). ________
   8. Purchase of goods and materials. ________
   9. Other (itemize if over $250.00-use separate schedule if necessary. ________

   TOTAL SPENT FOR ORDINARY OPERATIONS: $ ________
   B. Payments to secured parties (list below and indicate basis of payment, i.e., court order): $ ________

C. Administrative Disbursements (non-business expenses relating to Chapter 11):

1. Appraiser's fees and expenses.* ________
2. Accountant's fees and expenses.* ________
3. Other Administrative Disbursements (itemize) ________

____
____
____

TOTAL accountant fees paid to date.
$ ____________________________________
____

TOTAL ADMINISTRATIVE DISBURSEMENTS $ ________

TOTAL DISBURSEMENTS $ ________

4. Cash and Bank Account balances at inception of Chapter 11.
5. Total Cash and Bank Account balances at end of Current Reporting Period (items 1, plus 2, minus 3). $ ________
6. Itemize cash and all bank balances invested funds, as of end of Reporting Period. Provide account numbers; identify payroll, tax and other special accounts. (The total must equal the bal ance shown in #5).
Debtor-in-possession Accounts:

DEPOSITORY	ACCT.NO.	TYPE ACCT.	BALANCE
1. ________			$ ________
2. ________			$ ________
3. ________			$ ________
4. ________			$ ________
5. ________			$ ________
		SUB TOTAL	$ ________

7. Petty Cash on Hand $ ________

TOTAL $ ________

8. ADD: Total Receipts from inception of Chapter 11 to end of Reporting Period: $ ________
9. LESS: Total Disbursements from inception of Chapter 11 to end of Reportiong Period: $ ________

*Cannot be paid without Court Order.

10. Total Cash and Bank Account Balances at end of Current Reporting Period - per item #5. $______
11. Total deposited into Special Tax Account this period for Payroll Taxes: (Attach Federal Deposit Receipts.) $______

SUMMARY OF OPERATIONS

12. Total Sales of Mdse./Services during the Current Reporting Period: $______
13. Inventory: Quantities based on physical count ( ) visual estimate ( ), other ( ) describe.
    A. Inventory at inception of Chapter 11. ______
    B. Inventory at beginning of Reporting Period. ______
    C. Inventory purchased during Reporting Period. ______
    D. Inventory sold during Reporting Period. ______
    E. Inventory on hand at end of Current Reporting Period. ______
14. Accounts Receivable:
    A. Accounts receivable at inception of Chapter 11 ______
    B. Accounts receivable at beginning of Reporting Period. ______
    C. Accounts receivable created during Reporting Period. ______
    D. Accounts collected during Reporting Period: Pre-11____ Post-11____ ______
    E. Balance accounts receivable at end of reporting period: Pre-11____ Post-11____** ______
    F. Attach schedule of accounts receivable 90 days and over, plus any other doubtful accounts. Describe collection efforts. ______
15. Itemize all unpaid obligations, including accruals for utilities, rent, salaries, etc. post Chapter 11.

TOTAL

**State Amount Due for Liens for Post Receivables.

16 Status of insurance coverage, payment and proof of premium payments (see Operating Guidelines):

17. Remarks:

DEBTOR-IN-POSSESSION ______

By: ______

Position ______

DATED: ______

When Can the Owners Participate in the Reorganized Debtor?: Cram Down as a "Shield" for Creditors

JAMES M. CARR*

I. INTRODUCTION

The goal in most cases under Chapter 11 of the Bankruptcy Code[1] is confirmation by the Bankruptcy Court of a reorganization plan that will provide for the distribution of the going concern value of the debtor business to creditors and owners.[2] A confirmed plan represents resolution of the inherent conflict between the interests of the business' owners and creditors. The owners typically want the company to stay in business and they wish to continue to own the business after confirmation. The creditors want to be paid as fully and as quickly as possible. Usually, creditors either want to sell the assets of the debtor business immediately in order to reduce or satisfy their claims, or they want to own the business so that all profits will be used for payment of their claims.

The goal of a confirmed plan of reoganization can usually be achieved only if the conflict between the interests of the owners of the business and the claims of creditors can be amicably resolved. Sometimes the conflict is resolved by litigation to determine the value of the company on a going concern basis and how that value is to be distributed. More frequently, the owner/creditor conflict is resolved by bargaining.

An owner can retain an ownership interest under a confirmed plan if (1) there is equity in the company in the sense that the deb-

---

*Member of the firm of Baker & Daniels; A.B., Indiana University, 1972; J.D., Indiana University—Bloomington, 1975.

[1]11 U.S.C. §§ 1101-1174 (Supp. IV 1980). Chapter 11 of the Code consolidates former Chapters X, XI, and XII of the Bankruptcy Act into a single business reorganization chapter.

[2]This Article will discuss only Chapter 11 cases in which a reorganization plan is based upon an on-going business; however, the Code also allows for liquidation of a debtor under Chapter 11 ("a liquidating 11"). 11 U.S.C. § 1123(b)(4) (Supp. IV 1980). *See, e.g., In re* L.N. Scott Co., 13 Bankr. 387 (E.D. Pa. 1981) (all tangible assets sold at public sale); *In re* Tele/Resources, Inc., 6 Bankr. 628 (S.D.N.Y. 1980) (debtor and secured creditor were permitted to sell a depreciable asset over the objection of an unsecured creditor who wanted to convert the case into a Chapter 7 liquidation).

A debtor in possession may also effect a liquidation by converting a voluntary Chapter 11 into a Chapter 7 liquidation. 11 U.S.C. § 1112(a) (Supp. IV 1980). A party in interest, however, may only effect a conversion for cause and after notice and hearing. *Id.* § 1112(b). *See, e.g., In re* Commercial Finance Corp. of Nev., 3 BANKR. L. REP. (CCH) ¶ 68,480 (D.D.C. Dec. 16, 1981) (U.S. trustee may move to convert a Chapter 11 when the debtor is unable to pay the administrative expenses of the bankruptcy proceeding).

tor's going concern value exceeds its debts;[3] or (2) all *classes* of creditors who will not be paid in full under the plan agree that the owners can retain an ownership interest, and all *creditors* who do not consent to the proposed plan will receive at least as much under the plan as they would receive if the debtor were liquidated under Chapter 7 of the Bankruptcy Code;[4] or (3) the owner contributes "money or money's worth" to the reorganized debtor and receives an ownership interest equal in value to that contribution.[5] This Article will discuss the above circumstances under which the owners of a debtor enterprise can retain an ownership interest following confirmation, and those instances in which creditors might consent to the owner's retention of an ownership interest.

II. Financial Standards Required for Confirmation

In a liquidation case under Chapter 7 of the Code,[6] the trustee either sells or appraises the assets of the business debtor,[7] and then distributes the sale proceeds or the assets at their market or appraised value to satisfy the claims of creditors and interests of owners in accordance with the priorities of their claims.[8] Although there is often argument in Chapter 7 cases about the valuation of assets, most such arguments can be resolved by simply offering the assets for sale and realizing their liquidation value.[9] The problem of determining and distributing the value of the debtor's assets in a Chapter 11 case is more complex because the method of valuation, and therefore the value to be distributed, is determined by "the purpose of the valuation and of the proposed disposition or use of such property."[10] That analysis[11] will determine whether a liquidation value or a "going concern value," that is, the future business earnings of the company discounted by an appropriate capitalization rate,[12] will be the appropriate method of valuation. If the Chapter 11

---

[3]*See* notes 44-46 *infra* and accompanying text.

[4]*See* notes 19-22, 47-48 *infra* and accompanying text.

[5]Case v. Los Angeles Lumber Co., 308 U.S. 106, 121 (1939). *See* notes 49-62 *infra* and accompanying text.

[6]11 U.S.C. §§ 701-766 (Supp. IV 1980).

[7]*Id.* §§ 327(a), 363.

[8]*Id.* §§ 501-510, 726.

[9]At a sale of a debtor's assets, secured creditors may bid ("credit bid") their claims and, if successful, may offset the amount of the secured claim against the purchase price and pay the trustee the balance remaining. *Id.* § 363(k).

[10]*Id.* § 506(a). *See* Pachulski, *The Cram Down and Valuation under Chapter 11 of the Bankruptcy Code*, 58 N.C.L. Rev. 925, 951-53 (1980).

[11]*See* notes 17-26 *infra* and accompanying text.

[12]The two basic components of a capitalization rate are the time value of money and risk. Pachulski, *supra* note 10, at 939-41. To establish an appropriate capitalization

case is based upon continuation of the business, then the projected going concern value is the appropriate method of valuation.[13]

As anyone who has even dabbled in the stock market can attest, it is extremely difficult to predict with any precision how a business with a history of success will perform in the future. It is certainly much more difficult to value the future performance of a business that requires relief under the Bankruptcy Code because of past financial or managerial ills.[14]

Largely because of the intrinsic difficulty of precisely establishing this value, confirmation of a plan is usually achieved because the interested parties bargain and reach a compromise of their conflicting claims based upon their "gut" feelings concerning the likelihood that the reorganized debtor will or will not be successful in the future. If not all interested parties can agree upon a method for distributing the value of the debtor business, then a proposed plan cannot be confirmed unless the Bankruptcy Court determines that the objecting class or party is being adequately treated under the plan in accordance with certain financial standards or tests contained in section 1129 of the Code.[15] The Bankruptcy Court can make such a determination only as part of valuation litigation that may be time-consuming and expensive.[16] The bargaining that leads to confirmation should take place against the backdrop of these section 1129 tests. Attorneys representing creditors should understand these tests in order to secure the best possible result for their clients.

The two tests set out in section 1129 are referred to as "the

---

rate, two questions must be answered. First, what would a relevant market establish as the risk-free time value of the anticipated earnings stream of the business? Second, how likely is it that the company will actually produce the projected earnings? *Id.*

[13]*See, e.g.*, Consolidated Rock Prods. Co. v. Du Bois, 312 U.S. 510, 525 (1941). *In re* Duplan Corp., 9 Bankr. 921, 924-29 (S.D.N.Y. 1980) (decided under the Act).

[14]The determination of the debtor's going concern value has been characterized as a " 'guess compounded by an estimate.' " H.R. REP. NO. 595, 95th Cong., 1st Sess. 225 (1977), *reprinted in* [1978] U.S. CODE CONG. & AD. NEWS 5963, 6184 [hereinafter cited as HOUSE REPORT]. *See, e.g.*, Consolidated Rock Prods. Co. v. Du Bois, 312 U.S. 510, 526 (1941) ("Since its application requires a prediction as to what will occur in the future, an estimate, as distinguished from mathematical certitude, is all that can be made.").

[15]11 U.S.C. § 1129 (Supp. IV 1980).

[16]The bargaining leverage provided shareholders of the debtor corporation by the threat of an unwanted valuation hearing is a strategic device intended by the law's drafters and noted by commentators. *See* Labovitz, *Outline of "Cram Down" Provisions Under Chapter 11 of the Bankruptcy Reform Act of 1978*, 86 COM. L.J. 51, 52-53 (1981).

best interests" test,[17] and the fair and equitable test.[18] Assuming that all other requirements[19] for confirmation have been satisfied, the best interests test is applied when a creditor rejects the plan but is a member of a *class* of "impaired"[20] creditors that has otherwise accepted the plan by the requisite majorities.[21] The best interest test requires that a dissenting *creditor* receive at least as much under the proposed plan as that creditor would receive if the debtor company were liquidated under Chapter 7 of the Code.[22] If a

---

[17]11 U.S.C. § 1129(a)(7)(A)(ii) (Supp. IV 1980) (former version at 11 U.S.C. §§ 366(2), 472(2) (1976) (repealed 1978)). *See* United Properties, Inc. v. Emporium Dep't Stores, Inc., 379 F.2d 55 (8th Cir. 1967); Technical Color & Chem. Works, Inc. v. Two Guys from Massapequa, Inc., 327 F.2d 737 (2d Cir. 1964) as examples of courts applying the best interests test under Chapter XI of the former Bankruptcy Act.

[18]11 U.S.C. § 1129(b)(1) (Supp. IV 1980) (former version at 11 U.S.C. § 221(2) (1976) (repealed 1978)). The Code also states that a plan shall not "discriminate unfairly" with regard to each impaired class of creditors that does not accept the plan. 11 U.S.C. § 1129(b)(1) (Supp. IV 1980). *See* Pachulski, *supra* note 10, at 936-38.

[19]11 U.S.C. § 1129(a)(1)-(6), (8)-(11) (Supp. IV 1980). Subsections (a)(1) and (a)(2) require that the plan and its proponent also comply with other requirements of Chapter 11 such as sections 1123 (contents of a plan) and 1125 (disclosure).

[20]Section 1124 of the Code lists three ways in which a class of claims or interests is left unimpaired. *Id.* § 1124.

[21]*See id.* § 1126(c)-(d) (voting majorities necessary for acceptance of a plan by a class of creditors or other interests).

If a class of creditors is not impaired, then it will be deemed to have accepted the plan as a matter of law. 11 U.S.C. § 1126(f) (Supp. IV 1980). If deemed acceptance satisfies the requirement of *id.* § 1129(a)(10) that one class of claims must accept the plan, a plan might be confirmed even if "not [actually] accepted by *any* impaired class." Pachulski, *supra* note 10, at 927 (emphasis in original). *See, e.g.*, *In re* Landau Boat Co., 13 Bankr. 788 (W.D. Mo. 1981); *In re* Bel Air Assocs., 4 Bankr. 168 (W.D. Okla. 1980). *But see In re* Barrington Oaks Gen. Partnership, 15 Bankr. 952, 967-970 (W.D. Mo. 1981) (legislative history mandates that one class must affirmatively accept the plan); Buffalo Sav. Bank v. Marston Enters., Inc. (*In re* Marston Enters., Inc.), 13 Bankr. 514, 518-21 (E.D.N.Y. 1981) (section 1126(f) only raises a rebuttable presumption).

Courts have likewise construed section 1125(b), which requires a disclosure statement to creditors, as not applicable to a creditor who has been deemed to have accepted the plan under section 1126(f), because the debtor will not need to solicit the vote of that creditor. *See In re* Union County Wholesale Tobacco & Candy Co., 8 Bankr. 442 (D.N.J. 1981); *In re* Bel Air Assocs. Ltd., 4 Bankr. at 174-75 (dicta) (plan itself functioned as a disclosure statement). *But see In re* Northwest Recreational Activities, 4 Bankr. 43, 45 (N.D. Ga. 1980) (written disclosure statement mandatory in all instances).

[22]11 U.S.C. § 1129(a)(7)(A)(ii) (Supp. IV 1980). *See, e.g.*, *In re* Martin's Point Ltd., 12 Bankr. 721 (N.D. Ga. 1981).

The best interests standard does not apply to those partially-secured creditors who have elected under section 1111(b)(2) to have their claims treated as fully secured for purposes of Chapter 11. 11 U.S.C. § 1129(a)(7)(B) (Supp. IV 1980). *See generally* 5 Collier on Bankruptcy ¶ 1129.03[4][b] (15th ed. L. King 1981) [hereinafter cited as Collier] for an explanation of the relationship between section 1129(b) and section 1111(b)(2).

whole *class* of impaired creditors rejects a proposed plan,[23] the Bankruptcy Court upon the request of the plan's proponent[24] may confirm the plan notwithstanding nonacceptance if, with respect to each dissenting class, the plan does not discriminate unfairly[25] and the fair and equitable test is satisfied based on an analysis of the debtor's going concern value rather than its liquidation value.[26]

The fair and equitable test can be both a "shield" for creditors and a "sword" for debtors.[27] As a shield, it establishes, among other things, the minimum recovery that a creditor must receive if the owners of the debtor business will retain an ownership interest under the plan solely because they owned the business prior to the bankruptcy filing. When utilized as a sword to obtain confirmation of a plan over the objection of creditors, the fair and equitable doctrine is referred to as "cram down."[28]

The concept of fair and equitable has been part of bankruptcy law for many years, and has become a term of art that has been amplified by earlier court decisions, including those of the Supreme Court.[29] As will be discussed below, there are questions about the fair and equitable doctrine, however, that are not answered by the Code itself. A lawyer may have to look at case law decided both

---

[23]Under section 1129(a)(8), each class must either accept a plan or not be impaired. 11 U.S.C. § 1129(a)(8) (Supp. IV 1980).

[24]The court will not confirm a section 1129(b) plan unless requested, nor will the court rewrite a plan. HOUSE REPORT, *supra* note 14, at 413. *See, e.g., In re* K.C. Marsh Co., 12 Bankr. 401 (D. Mass. 1981). If multiple plans are submitted to the court, the court must decide which one should be confirmed after considering the preferences of creditors and equity security holders. 11 U.S.C. § 1129(c) (Supp. IV 1980).

[25]"The criterion of unfair discrimination . . . preserves just treatment of a dissenting class from the class's own perspective." HOUSE REPORT, *supra* note 14, at 417-18. See generally 5 COLLIER, *supra* note 22, at ¶ 1129.03[3][b]; Pachulski, *supra* note 10, at 936-38 for an explanation and application of this requirement.

[26]This valuation method was judicially developed as part of the fair and equitable test which was previously part of Chapter 10 of the Bankruptcy Act. 11 U.S.C. § 621(2) (1976) (repealed 1978). *See* notes 11-13 *supra* and accompanying text.

[27]Note, *From Debtor's Shield to Creditor's Sword: Cram Down Under the Chandler Act and the Bankruptcy Reform Act*, 55 CHI.-KENT L. REV. 713 (1979).

[28]*See generally* Blum, *The "Fair and Equitable" Standard For Confirming Reorganizations Under the New Bankruptcy Code*, 54 AM. BANKR. L.J. 165 (1980); Klee, *All You Ever Wanted to Know About Cram Down Under the New Bankruptcy Code*, 53 AM. BANKR. L.J. 133 (1979) for a detailed analysis of section 1129(b) and specific examples illustrating the application of cram down.

[29]*See, e.g.*, Protective Comm. v. Anderson, 390 U.S. 414, 441 (1968); Marine Harbor Properties, Inc. v. Manufacturers Trust Co., 317 U.S. 78, 85 (1942); Consolidated Rock Co. v. Du Bois, 312 U.S. 510, 527 (1941); SEC v. United States Realty & Improvement Co., 310 U.S. 434, 452 (1940); Case v. Los Angeles Lumber Prods. Co., 308 U.S. 106, 115-17 (1939); Northern Pac. Ry. v. Boyd, 228 U.S. 482, 508 (1913); *see also* Caplin v. Marine Midland Grace Trust Co., 406 U.S. 416, 435-38 (1972) (Douglas, J., dissenting).

under the Code and prior bankruptcy statutes to determine whether a certain plan is fair and equitable.

There are two additional preliminary matters that should be noted about the fair and equitable rule. First, section 1129 requires *only* that a plan be fair and equitable as to any *class* that has not accepted the plan.[30] Therefore, the fair and equitable test is called into effect only with respect to those classes of creditors who have rejected the plan. This represents a modification of the "absolute priority rule" which was an interpretation of the fair and equitable requirement under Chapter X of the Bankruptcy Act.[31] Second, the Code does not specify *all* conditions under which a plan can be considered fair and equitable with respect to an objecting class. Section 1129(b) contains both an overriding general requirement that a plan be fair and equitable, and certain specific tests that are included within the general requirement but which do not exhaust all possible situations.[32]

A proposed plan of arrangement places creditors and owners in various classes.[33] The fair and equitable requirement specifically ap-

---

[30]11 U.S.C. § 1129(b)(1) (Supp. IV 1980).

[31]Earlier decisions construing Chapter 10 of the Act established that the fair and equitable test included the "absolute priority" rule. Under this interpretation, no class could receive anything of value until senior classes received full compensation for the value of their claims. Only if the debtor was solvent after all creditors had been paid, could provision be made for stockholders. *See* cases cited note 29 *supra.*

The absolute priority rule under the Bankruptcy Act was criticized because "the rigidity of the rule frequently resulted in the destruction rather than the protection of interests of public investors." COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, REPORT, pt. 1, H.R. DOC. NO. 137, 93d Cong., 1st Sess. 256 (1973) [hereinafter cited as COMMISSION REPORT]. *See* Note, *The Proposed Bankruptcy Act: Changes in the Absolute Priority Rule for Corporate Reorganizations*, 87 HARV. L. REV. 1786, 1787 n.7 (1974) (collecting commentary). The absolute priority rule, as embodied in the Bankruptcy Code, was modified to partially alleviate this result. Under this modified version:

> [T]he fair and equitable requirement applies only with respect to dissenting classes. Therefore, unlike the fair and equitable rule contained in chapter X and section 77 of the Bankruptcy Act under section 1129(b)(2), senior accepting classes are permitted to give up value to junior classes as long as no dissenting intervening class receives less than the amount of its claims in full.

124 CONG. REC. 32,407 (1978) (remarks of Rep. Don Edwards).

[32]11 U.S.C. § 1129(b)(2) (Supp. IV 1980). Additional factors which are essential to an analysis of fair and equitable, and which were included in the House report, HOUSE REPORT, *supra* note 14, at 413-18, were left out of section 1129(b) to avoid "statutory complexity and because they would undoubtedly be found by a court to be fundamental to 'fair and equitable treatment' of a dissenting class." 124 CONG. REC. 32,407 (1978) (remarks of Rep. Don Edwards).

[33]*Id.* § 1123(a)(1); *see id.* § 1122 (classification of claims or interests). *See, e.g., In re* Martin's Point, Ltd., 12 Bankr. 721 (N.D. Ga. 1981); Julis, *Classifying Rights and Interests*, 55 AM. BANKR. L.J. 223 (1981).

plies to each class of secured creditors,[34] unsecured creditors[35] or interest holders[36] provided for under the plan. This Article will deal only with the fair and equitable doctrine as it aplies to the retention of some ownership interest under a reorganization plan by the pre-filing owners of a debtor business.

III. Participation in a Plan By Pre-filing Owners

If the debtor files a voluntary Chapter 11 petition, the owners of the debtor company most likely intend to retain an ownership interest after confirmation. However, this is not true in every case. For example, the owners of a debtor business may file a Chapter 11 petition because they guaranteed or are otherwise personally liable for some of the business debts, and want to avoid a forced sale of the business assets, in order to avoid or minimize a deficiency for which they might be liable. In that case, the owners may elect to file a Chapter 11 petition solely to take advantage of the repose afforded by the automatic stay provided by section 362 while they arrange an orderly sale of assets.[37] The owners of the debtor business may also want to use the leverage of the bankruptcy stay to prolong their jobs and salaries, or they may believe that a bankruptcy case will facilitate their purchase of the assets of the business.

Notwithstanding these alternative considerations, one would expect in the typical Chapter 11 case that the owners intend to retain an ownership interest in the business following reorganization. The general goal of creditors, on the other hand, is to maximize their recovery from the business by recovering everything of value from the business until they are paid in full. If a quick sale is not feasible, then creditors want to control the business to prevent further loss and to insure that payment will be received as quickly as possible. As noted above,[38] these conflicting goals are usually resolved by bargaining which is conducted against the statutory backdrop of the fair and equitable rule.

The fair and equitable rule states that a plan must provide either that an impaired non-accepting class of creditors be paid in full with respect to their claims, or that no interest junior to that class of creditors receive any distribution under the plan *with respect to* the junior claimants' pre-filing interest.[39] That means that

---

[34] 11 U.S.C. § 1129(b)(2)(A) (Supp. IV 1980).

[35] *Id.* § 1129(b)(2)(B).

[36] *Id.* § 1129(b)(2)(C).

[37] *Id.* § 362. See generally Kennedy, *The Automatic Stay in Bankruptcy*, 11 U. Mich. J.L. Ref. 177 (1978) for a discussion of the uses of the stay under the Bankruptcy Act, and the factors considered by a court in granting relief from the stay. *See also* Kennedy, *Automatic Stays Under the New Bankruptcy Law*, 12 U. Mich. J.L. Ref. 1 (1978).

[38] *See* notes 29-30 *supra* and accompanying text.

[39] 11 U.S.C. § 1129(b)(2)(B) (Supp. IV 1980).

if a class of creditors rejects a proposed plan under which the owners of the company are to retain an ownership interest, the Bankruptcy Court cannot confirm the plan unless it finds that the creditors will be paid *in full* under the plan.[40] Therefore, owners can only retain their ownership interest solely because of their pre-filing status if (1) there is sufficient going concern value to pay all objecting creditors and the plan provides for full payment (either by payment in full upon confirmation or by distributions over time from the future earnings in a manner that satisfies the Court that the objecting creditors will in fact receive payments whose present value at the date of confirmation is equal to their claims, or (2) every class of creditors that will receive less than full payment accepts the plan.

Before elaborating upon the circumstances under which owners of a debtor business may retain their ownership interest under a confirmed plan, it is necessary to describe what a reorganization plan should accomplish. A debtor business has a certain going concern value. As described above,[41] that value is the result of an informed estimate of the earnings stream of the business over its projected business life discounted to a present value. A reorganization plan provides for the distribution of that going concern value to the various creditor and ownership interests. This is easiest to describe and to understand by using a model.

As a model, one might think of the going concern value as sand and the various creditor and ownership interests as boxes aligned according to their order of priority. The alignment depends upon a mixture of state law, the Code's provisions granting priority to certain claims, and the equitable principles of bankruptcy law.[42] A Bankruptcy Court, however, should be guided in applying section 1129 by the overriding concept that an insolvent business is a trust fund for payment of creditors and that equality of distribution is equity.[43] When a creditor or owner is entitled to payment before another, he is said to have a "senior" right to payment. Under the fair and equitable rule a plan must provide that the going concern value, that is, the sand in our model, is poured into the boxes in their order of priority and no box junior to a senior box may receive any sand unless the prior box is filled or its owner has agreed to accept less than full payment.

---

[40]*See* notes 15-16 *supra* and accompanying text.

[41]*See* notes 12-14 *supra* and accompanying text.

[42]See generally COLLIER, *supra* note 22, at ¶ 1122.03; 6 COLLIER ON BANKRUPTCY, pt. 2, ¶ 9.13[1] (14th ed. J. Moore 1978) for a discussion of classification of claims under both the Code and the Act.

[43]*See, e.g.*, Northern Pac. Ry. Co. v. Boyd, 228 U.S. 482, 504 (1913); Merrill v. National Bank of Jacksonville, 173 U.S. 131, 136 (1899).

A. Creditor Acceptance of a Plan

It is usually difficult and expensive to establish a going concern value to the satisfaction of all parties; thus, the fair and equitable rule promotes bargaining because it is applied only if a class of creditors rejects the plan.[44] One of the first questions that a creditor must answer in determining whether he should reject a plan that would allow the owners to retain their ownership interest is whether the business is solvent. A company is solvent if there is sufficient going concern value to "trickle down" to the owners after paying in full all creditors who demand full payment. If there is clearly equity in the business because there is more than sufficient going concern value to pay all creditors, then there is no need for the owners of the debtor business to obtain the consent of creditors.[45] However, it is rarely certain that there is sufficient going concern value to provide for full payment of all creditors and allow the owners to retain their ownership interest. If there is clearly equity in the company, then the only real issue that will be the subject of bargaining or litigation is that of *when* the creditors will be paid.[46]

In most cases, it will either be doubtful whether there is sufficient going concern value to pay all creditors in full and still provide an equity for the owners, or relatively clear that there is no equity. In either of these instances, the owners will need to obtain the consent of creditors if the owners are to retain an ownership interest. There are several reasons, however, why creditors might give their consent, even though there is no equity in the business. They might do so if creditors cannot propose a better plan, that is, a plan that would generate a larger recovery without the agreement and cooperation of the owners, or a commitment that the owners will participate in the business following confirmation.[47] Creditors might not be able to propose a better plan without the participation of the owners if the owners possess management, sales, or other skills that

---

[44]*See* note 16 *supra.*

[45]A plan will be unfair and inequitable as to stockholders if senior creditors are to be paid in excess of their claims while stockholder interests remain impaired. Klee, *supra* note 28, at 148-50.

[46]*See, e.g., In re* Hollanger, 15 Bankr. 35 (W.D. La. 1981).

[47]If the owners and shareholders of a business are completely eliminated from participation in a proposed plan, that class of interests is deemed to have rejected the plan, 11 U.S.C. § 1126(g) (Supp. IV 1980), resulting in an expensive and time-consuming going concern valuation to ensure that senior classes will not receive more than full payment, or a "bonus." *See* 5 Collier, *supra* note 22, at ¶ 1129.03[4][g]. This clearly increases the bargaining power of owners and shareholders. *See* Labovitz, *supra* note 16, at 53-54.

are essential to the business, or if litigation with the owners over an alternative creditor plan might harm the going concern value of the business. In either case, creditors must then decide whether they would recover more by liquidation of the business assets than they would under the debtor's plan.[48]

In connection with that decision, a creditor should take into consideration whether it is advantageous to maintain the debtor as a going business entity to serve as either a buyer of the creditors' goods or services, or as a supplier. If an individual principal of the debtor guaranteed a debt to a creditor, the creditor must also consider whether a liquidation of the debtor business may be followed by bankruptcy of the guarantor with a reduced likelihood of recovery. The creditor in that case must decide whether the combination of his share of the projected profits from the business, plus anticipated payment of all or some of the deficiency by the guarantor-principal funded by the principal's income from the business, will be greater than the creditor's dividend if the company is liquidated and the guarantor-principal is forced to seek relief under the Bankruptcy Code. After taking these factors into consideration, if creditors agree to the reorganization plan, even though there is no equity in the business, a plan may be confirmed which allows the owners to retain their ownership interest.

B. Owner Participation in an Insolvent Company Despite Creditor Dissent

If there is clearly insufficient going concern value to fully satisfy the obligations of creditors, and creditors do not agree to a plan which allows the owners to retain an ownership interest, then the owners may not retain their ownership interest *with respect to their pre-filing interest in the business.* There may be circumstances, however, under which the owners can be granted an ownership interest and in effect continue as owners after confirmation of the plan even though the company is insolvent and creditors do not agree to the owners retaining ownership. In that case, their continuing ownership must arise from some new contribution to the reorganized debtor. For example, if the business would be materially aided by an injection of new capital, then the owners of the business may make a new capital contribution and receive an ownership interest in the reorganized company with respect to that new

---

[48]The fact that a creditor would receive less under liquidation than by accepting the debtor's plan, is not a factor in determining whether that plan is fair and equitable. Case v. Los Angeles Lumber Prods. Co., 308 U.S. 106, 123 (1939), *quoted in In re* Landau Boat Co., 8 Bankr. 436, 438 (W.D. Mo. 1981).

contribution in the same manner as any other investor.

In *Case v. Los Angeles Lumber Products Co.*,[49] the Supreme Court set forth the conditions that must be met before the fair and equitable doctrine will allow the owners of a debtor business to receive an ownership interest in the reorganized company because of a new contribution to the business. The Court held that there must first be a need by the company for the contribution, and second, that the ownership interest received by the owners must be the fair equivalent of the contribution they made.[50] The Court required that the contribution of shareholders or other owners must be in "money or money's worth,"[51] raising the question of what types of contributions other than an injection of cash would satisfy the fair and equitable rule and allow an owner to receive an ownership interest.

Los Angeles Lumber held under the particular facts of the case that the stockholders' " 'financial standing and influence in the community' " and their ability to provide a " 'continuity of management' constitute[d] no legal justification for issuance of new stock to them."[52] The Court said that:

> Such items are illustrative of a host of intangibles which, if recognized as adequate consideration for issuance of stock to valueless junior interests would serve as easy evasions of the principle of full or absolute priority of *Northern Pacific Ry. Co. v. Boyd* . . . and related cases. Such items, on facts present here, are not adequate consideration for issuance of the stock in question. *On the facts of this case* they cannot possibly translate it into money's worth reasonably equivalent to the participation accorded the old stockholders. They have no place in the asset column of the balance sheet of the new company. They reflect merely vague hopes or possibilities.[53]

Accordingly, the Court held that the plan did not satisfy the absolute priority interpretation of the fair and equitable requirement under Chapter X, because the stockholders retained an ownership interest although the debtor's bondholders had not been paid in full.[54]

---

[49]308 U.S. 106 (1939).

[50]*Id.* at 121.

[51]*Id.* at 122.

[52]*Id.*

[53]*Id.* at 122-23 (emphasis added).

[54]*Id.* at 123. *Los Angeles Lumber* represents a classic application of the absolute priority rule as it existed prior to the present Bankruptcy Code. *See* note 31 *supra*.

The opinion of the Supreme Court in *Los Angeles Lumber* leaves open the possibility that shareholders or other owners of a debtor business could in fact prove that intangible contributions such as management or other skills that the owners agree to provide after confirmation, have a measurable value to the reorganized company and could therefore be the basis for the receipt by the old owners of an ownership interest in the reorganized company. Supreme Court cases decided after *Los Angeles Lumber*, however, have cast very little light upon the question.[55] That possibility once again raises the very important question of valuation and highlights the need for bargaining prior to submission of a plan for confirmation.

The application of these principles by the progeny of *Los Angeles Lumber* in the lower federal courts has done little to flesh out the conditions of shareholder participation in a reorganized debtor. These decisions, reached under Chapter X of the Bankruptcy Act and its predecessors, consistently held that when there was a demonstrable need to finance a reorganization plan,[56] the shareholders could retain an interest in the reorganized company if they contributed money or money's worth,[57] and their participation

---

Even though all classes in *Los Angeles Lumber* had agreed to the debtor's plan, the court nevertheless rejected the plan because senior classes were not paid in full. The plan would have been accepted under the present modified version of the absolute priority rule. *See id.* and accompanying text. The requirements for stockholder participation as stated in *Los Angeles Lumber* have survived, however. *See* note 62 *infra.*

[55]*See* cases cited *supra* note 29. *But cf.* Horowitz v. Kaplan (*In re* Waltham Watch Co.), 193 F.2d 64 (1st Cir. 1951), *cert. denied*, 342 U.S. 9046 (1952), which suggests that the absolute priority rule will not bar participation if the management skills are essential to the success of the business. The court of appeals in *Horowitz* distinguished *Los Angeles Lumber* because in *Horowitz*, participation was limited to only those stockholders who were part of management and there was a binding contract by management to remain in that capacity. 193 F.2d at 73-75.

The Commission on the Bankruptcy Laws of the United States also believed that this aspect of the absolute priority rule should be altered. Relying on the district court decision in *In re* Los Angeles Lumber Prods. Co., 24 F. Supp. 501 (S.D. Cal. 1938), *aff'd sub nom.* Case v. Los Angeles Lumber Prods. Co., 100 F.2d 963 (9th Cir.), *rev'd*, 308 U.S. 106 (1939), the Commission recommended that a revised bankruptcy law should permit participation based on management skills. COMMISSION REPORT, pt. 2, *supra* note 30, at 254. The legislative history of the Bankruptcy Code, however, was silent on this issue. *See* note 61 *infra.*

[56]*See, e.g.*, First Nat'l Bank of Herkimer v. Poland Union, 109 F.2d 54 (2d Cir. 1940); *In re* Associated Owners, Inc., 32 F. Supp. 828 (E.D. Wis. 1940). *See also In re* Dutch Woodcraft Shops, 14 F. Supp. 467, 471 (W.D. Mich. 1935) for an application of this condition prior to its recognition by the Supreme Court.

[57]*See, e.g.*, Muskegon Motor Stockholders Protective Comm. v. Davis (*In re* Muskegon Motor Specialties), 366 F.2d 522, 525, 530 (6th Cir. 1966); SEC v. Canandaigua Enterprises Corp., 339 F.2d 14, 21 (2d Cir. 1964); *In re* Universal Lubricating

was equivalent to their contribution.[58] Courts generally rejected all attempts, however, to expand the conditions of participation beyond those laid out in *Los Angeles Lumber*, and treated such challenges as a threat to the "absolute priority rule."[59]

The Bankruptcy Code adopted a "partial codification of the absolute priority rule"[60] to respond to earlier criticism by commentators. However, the legislative history indicates that little attention was paid to the effect of this rule upon shareholder participation in reorganized debtors.[61] The Code, however, does not prohibit stockholder participation under the conditions set out in *Los Angeles Lumber*. As a result, several bankruptcy courts[62] have ap-

---

Systems, 71 F. Supp. 775, 785-88 (W.D. Pa. 1947); *see also* Swanson v. Barclay Park Corp. (*In re* Barclay Park Corp.), 90 F.2d 595, 598 (2d Cir. 1937), *quoted in* Case v. Los Angeles Lumber Prods. Co., 308 U.S. 106, 123 n.16 (1939); *cf.* Spitzer v. Stichman (*In re* Hudson & Manhattan R.R. Co.), 278 F.2d 402, 405 (2d Cir. 1960) (contingent particpation rejected when creditors not fully compensated); *In re* Janson Steel & Iron Co., 47 F. Supp. 652, 655-57 (E.D. Pa. 1942) (capital advances made by stockholders prior to bankruptcy petition did not entitle them to share pari passu with general unsecured creditors).

[58]*See, e.g.*, Highland Towers Co. v. Bondholders' Protective Comm. of Highland Towers, 115 F.2d 58 (6th Cir. 1940); Metropolitan Holding Co. v. Weadock, 113 F.2d 207 (6th Cir. 1940). *See also* Sophian v. Congress Realty Co., 98 F.2d 499, 502 (8th Cir. 1938).

[59]*See, e.g.*, Kelce v. U.S. Financial Inc. (*In re* U.S. Financial Inc.), 648 F.2d 515 (9th Cir. 1980); Jezarian v. Raichle (*In re* Stirling Homex Corp.), 579 F.2d 206 (2d Cir. 1978), *cert. denied*, 439 U.S. 1074 (1979). In both cases, the courts rejected the argument that defrauded shareholders' claims should be accorded parity with unsecured creditors, a conclusion codified in the Bankruptcy Code. 11 U.S.C. § 510(b) (Supp. IV 1980). See generally Huff, *The Defrauded Investor in Chapter X Reorganizations: Absolute Priority v. Rule 10b-5*, 50 AM. BANKR. L.J. 197 (1976) for a comparison of the risks assumed by shareholders and creditors which supports this codification.

[60]*See* note 31 *supra*.

[61]*See* S. REP. NO. 989, 95th Cong., 2d Sess. 126-28 (1978); HOUSE REPORT, *supra* note 14, at 413-18; 124 CONG. REC. 34,007-08 (1978) (statement of Sen. De Concini); 124 CONG. REC. 32,406-08 (1978) (statement of Rep. Don Edwards); *but see* note 55 *supra* describing the Bankruptcy Commission's closer examination of this issue.

[62]*See, e.g., In re* Landau Boat Co., 13 Bankr. 788, 791-94 (W.D. Mo. 1981) (modified plan) (new money contribution and irrevocable commitment to a loan was a "substantial investment in excess of value to be received"); Buffalo Sav. Bank v. Marston Enters., Inc. (*In re* Marston Enters., Inc.), 13 Bankr. 514, 517-18 (E.D.N.Y. 1981) (participation after "a substantial necessary capital contribution"); *In re* Landau Boat Co., 8 Bankr. 436-39 (W.D. Mo. 1981) (first plan) (retention of ownership interest for purposes of "prospective earnings and control" failed fair and equitable test when unsecured creditors were not paid in full); *In re* Antilles Yachting, Inc., 4 Bankr. 470, 473-74 (V.I. 1980) (debtor stockholder barred from participation after he refused to contribute additional money); *see also In re* Liberal Market, Inc., 11 Bankr. 742, 743-44 (S.D. Ohio 1981) (application of absolute priority rule to appointment of trustee). *In re* Tele/Resources, Inc., 6 Bankr. 628, 631-32 (S.D.N.Y. 1980) (absolute priority doctrine precluded debtor stockholders from sharing in the proceeds of the sale of assets); *In re*

plied these principles in reorganization cases arising under Chapter 11. As with cases decided under the Bankruptcy Act, these few early decisions have not elaborated upon the conditions originally established in *Los Angeles Lumber.*

IV. Conclusion

The fair and equitable and best interests tests of section 1129 of the Code offer creditors protection from unwarranted participation by the pre-filing owners in the reorganized debtor. To obtain that protection, a creditor must speak up. To prevent confirmation of a plan under which a creditor will not realize maximum payment, the creditor must object by rejecting a plan that provides for the pre-filing owners to confirm their ownership interest in the reorganized company when (1) the creditor's class will not receive full payment under the plan; or (2) the creditor would fare better if the debtor was liquidated; or (3) the owners' new contribution to the reorganized debtor is not equal to the participation granted to the owners under the reorganization plan. However, before rejecting a proposed plan, a creditor should decide whether a better plan can be proposed that will receive the consent of owners and other interested parties, whether a better plan can be confirmed by the Bankruptcy Court without the consent of the owners, and how the creditor will fare under liquidation. The creditor must also consider the effect that litigation with the owners concerning valuation of the debtor on a going concern basis may have upon the company and the creditor's prospect of recovery. In many cases, this analysis should indicate to creditors, as well as to owners, that the parties will be better served by a negotiated compromise and that they should bargain to strike an equitable arrangement against the backdrop of the section 1129 tests.

Northwest Recreational Activities, Inc., 4 Bankr. 43, 48 (N.D. Ga. 1980) (participation in reorganzied corporation at 20% of original investment after all creditors agreed to plan).

The Plight of the Defaulting Mortgagor

SIGMUND J. BECK*

As any practitioner who has ever represented a bankrupt knows, there is one question that invariably arises at some time during the course of the first interview: "What about the house, can I keep it?" The response to this question requires thoughtful consideration of both the circumstances of the bankrupt[1] and the state of the law of bankruptcy in light of the Bankruptcy Reform Act of 1978.[2]

This Article will focus on the latter of the above considerations. Specifically, this Article examines the ability of a homeowner to use Chapter 13 to effect reinstatement of a mortgage upon which he is in default at the time he files bankruptcy.

In previous years, a homeowner who encountered financial difficulties, fell behind in his mortgage payments, and filed bankruptcy, had no difficulty in reinstating the mortgage provided he could assure the mortgagee of his continued earning capacity and ability to meet the payments. Savings and loan institutions and banks were only too willing to have a solid loan on their books.

With lending institutions now encountering financial difficulties of their own because of the high cost of money and the low fixed rates on outstanding mortgages, it is understandable that mortgagees desire to call the loan, if at all possible.

It is apparent that the filing of a Chapter 7 petition will in no way aid the embattled homeowner where default has occurred and the debt has been accelerated,[3] whether or not foreclosure has been instituted or judgment of foreclosure obtained. It is true that the right of redemption would be available to the debtor even after the filing of the petition. There is, however, little likelihood that redemption would be practical because new financing would be as difficult to obtain as restructuring the loan at a rate that would enable the debtor to consistently meet the payments due.

However, all is not lost.

Chapter 13 is being invoked by mortgagors at every

---

* Partner in the Indianapolis law firm of Bamberger & Feibleman; LL.B. University of Virginia, 1937.

[1]This Article does not attempt to treat problems relating to the distinctive economic realities of any particular situation, tenancy by the entirety, or exemptions.

[2]Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549 (codified at 11 U.S.C. §§ 101-151326 (Supp. IV 1980)) (enacted November 6, 1978, applicable to cases filed after September 30, 1979).

[3]*See, e.g.*, Cowan v. Murphy, 165 Ind. App. 566, 333 N.E.2d 802 (1975); Huston v. Fatka, 30 Ind. App. 693, 66 N.E. 74 (1903).

> stage of default: those who are only a few months in default; those whose mortgages have been accelerated, pursuant to contractual provisions authorizing such acceleration; those against whom judgments of foreclosure have been entered; and those whose property has already been sold.[4]

The use of Chapter 13 by debtors wishing to reinstate their mortgages has brought forth a number of interesting, as well as conflicting, decisions.

It is clear that Congress intended Chapter 13 to provide the individual who has regular income[5] a means to safeguard assets while rearranging debts, thereby according the individual relief comparable to that provided businesses under Chapter 11.[6] The provisions relating to the contents of a plan under Chapter 13 may be found in section 1322(b).[7] The applicable provisions should be compared with analogous provisions under Chapter 11: section 1123 discussing the contents of a plan[8] and section 1124 treating impair-

---

[4]*In re* Pearson, 10 Bankr. 189, 193 (E.D.N.Y. 1981).

[5]11 U.S.C. § 101(24) (Supp. IV 1980) defines "individual with regular income." "The definition encompasses all individuals with incomes that are sufficiently stable and regular to enable them to make payments under a chapter 13 plan." S. Rep. No. 989, 95th Cong., 2d Sess. 24, *reprinted in* [1978] U.S. Code Cong. & Ad. News 5787, 5810.

11 U.S.C. § 109(e) (Supp. IV 1980) specifies that an individual with regular income, or an individual with regular income and the individual's spouse, may proceed under Chapter 13.

"Increased access to the simpler, speedier, and less expensive debtor relief provisions of chapter 13 is accomplished by permitting debtors engaged in business to proceed under chapter 13." S. Rep. No. 989, 95th Cong., 2d Sess. 140, *reprinted in* [1978] U.S. Code Cong. & Ad. News 5787, 5926.

[6]*See* Di Pierro v. Cullen (*In re* Toddeo), 9 Bankr. 299, 303 (E.D.N.Y. 1981).

[7]11 U.S.C. § 1322(b) (Supp. IV 1980) provides in part that the contents of a plan may:

> (2) modify the rights of holders of secured claims, other than a claim secured claims, other than a claim secured only by a security interest in real property that is the debtor's principal residence, or of holders of unsecured claims;
>
> (3) provide for the curing or waiving of any default;
>
> . . .
>
> (5) notwithstanding paragraph (2) of this subsection, provide for the curing of any default within a reasonable time and maintenance of payments while the case is pending on any unsecured claim or secured claim on which the last payment is due after the date on which the final payment under the plan is due . . . .

[8]11 U.S.C. § 1123(a) (Supp. IV 1980) provides in part that a plan shall:

ment of claims or interests.[9] Although the treatment of secured debts is comparable under Chapters 11 and 13, mortgaged debt on the debtor's principal residence was intended to be covered by section 1322(b)(5).[10]

If one assumes, as has Bankruptcy Judge Parente of the Eastern District of New York, that the Chapter 13 debtor should have the same benefits as a Chapter 11 debtor, then reinstatement of the mortgage should be allowed on the same terms and conditions, including the contracted interest rate, upon curing the default.[11] Accordingly, it should be "the right of the Chapter 13 debtor, at any time prior to actual sale of the foreclosed property, to attempt cure of the pre-acceleration defaults and to reinstate the original mortgage payment schedule."[12]

---

(5) provide adequate means for the plan's execution, such as—

. . .

(E) satisfaction or modification of any lien;

(F) cancellation or modification of any indenture or similar instrument;

(G) curing or waiving any default . . . .

[9]11 U.S.C. § 1124 (Supp. IV 1980) concerning impairment of claims or interests provides in part:

> Except as provided in section 1123(a)(4) of this title, a class of claims or interests is impaired under a plan unless, with respect to each claim or interest of such class, the plan—
>
> (1) leaves unaltered the legal, equitable, and contractual rights to which such claim or interest entitles the holder of such claim or interest;
>
> (2) notwithstanding any contractual provision or applicable law that entitles the holder of such claim or interest to demand or receive accelerated payment of such claim or interest after the occurrence of a default—
>
> (A) cures any such default, other than a default of a kind specified in section 365(b)(2) of this title, that occurred before or after the commencement of the case under this title;
>
> (B) reinstates the maturity of such claim or interest as such maturity existed before such default;
>
> (C) compensates the holder of such claim or interest for any damages incurred as a result of any reasonable reliance by such holder on such contractual provision or such applicable law; and
>
> (D) does not otherwise alter the legal, equitable, or contractual rights to which such claim or interest entitles the holder of such claim or interest . . . .

[10]*See* 124 CONG. REC. 32,409 (1978); *see also* H.R. REP. NO. 595, 95th Cong., 1st Sess. 429 (1977).

[11]"Chapter 11 extends the right of post-acceleration cure to the business debtor, *a fortiori* the generally more liberal Chapter 13 provisions should do the same for the consumer debtor." Di Pierro v. Cullen (*In re* Toddeo), 9 Bankr. 299, 303 (E.D.N.Y. 1981).

[12]*Id.* at 302.

All is not that simple or clear, however. At the time of the drafting of this Article, there appeared to be no disagreement among courts that once a sale of the foreclosed property had been effected, Chapter 13 would avail the debtor little redress.[13] When nothing more has happened than a default in payment and no acceleration has taken place, it should not be too difficult to reach a decision that the debtor may cure the default.[14] Precedent has been established in previous cases under former Chapters X, XI, XII, and XIII, as well as in analogous cases relating to termination and default respecting leases under Chapter 11.[15] When, however, a foreclosure, but not a sale, has taken place, courts are in disagreement regarding the rights of the debtor under Chapter 13.

If Congress intended to help the honest debtor provide a way for repayment of his debt and at the same time retain his home, then regardless of whether a judgment of foreclosure or its equivalent had been entered, it would seem that payment of the back indebtedness should suffice to reinstate the mortgage.[16] This view must be contrasted with that of courts favoring the mortgagees and requiring full payment of the mortgaged debt where foreclosure has taken place.[17]

One court has apparently attempted to take a middle ground in concluding

> that after a judgment of foreclosure has been entered and a secured claim based on that judgment has been filed, a Chapter 13 plan, in order to satisfy the Code, must provide for the payment of that judgment *in full* over the life of the plan. Section 1325(a)(5)(B) is not satisfied simply by paying the arrearages that trigger the judgment. It is the judgment, not the mortgage, that now defines the lien of the judgment creditor.[18]

---

[13]*See In re* Butchman, 4 Bankr. 379 (S.D.N.Y. 1980). *But see* cases cited at note 24 *infra.*

[14]*See In re* Hartford, 7 Bankr. 914 (D. Me. 1981); *In re* Johnson, 6 Bankr. 34 (N.D. Ill. 1980).

[15]*See* Hallenbeck v. Penn Mut. Life Ins. Co., 323 F.2d 566 (4th Cir. 1964).

[16]*See* United Cos. Fin. Corp. v. Brantley, 6 Bankr. 178 (N.D. Fla. 1980); *In re* Breuer, 4 Bankr. 499 (S.D.N.Y. 1980).

[17]*See* Coleman v. Brown, 5 Bankr. 812 (W.D. Ky. 1980); Benford-Whiting Co. v. Robertson, 4 Bankr. 213 (D. Colo. 1980); *cf.* Retreat Inv. Corp. v. Canady (*In re* Canady), 9 Bankr. 428 (D. Conn. 1981) (reinstatement refused after acceleration); *In re* LaPaglia, 8 Bankr. 937 (E.D.N.Y. 1981) (reinstatement refused after acceleration). *But cf. In re* Soderlund, 7 Bankr. 44 (S.D. Ohio 1980) (reinstatement permitted after acceleration).

[18]*In re* Pearson, 109 Bankr. 189, 195 (E.D.N.Y. 1981) (emphasis by the court).

It would appear that this court has joined the philosophical group favoring mortgagees because there is little likelihood that a debtor seeking the aid of the Bankruptcy Court could manage to compress long term mortgage payments into a three year program.[19]

The question of which judicial view best implements the views of Congress depends upon which side of the aisle one favors. Judge Schwartzberg of Connecticut contends that there is no authority under Chapter 13 comparable to section 1124(2)(B) whereby an accelerated mortgage on a principal residence can be reinstated to take advantage of the extended date that existed before default.[20]

Contrast that with the view of the New York Judge Schwartzberg who apparently subscribes to the view that city dwellers ought not be pushed out of their homesteads any more than farmers.[21] He agrees that Chapter 13 does not permit a cure of the acceleration of a mortgage reduced to judgment prior to the filing of a petition.[22] But hold on to your hat: if the mortgage has been reduced to judgment, it merges into the judgment and the mortgagee can "no longer assert that its rights in the real estate are 'secured only by a security interest' under an existing consensual mortgage."[23] The mortgagee's rights are thus subject to modification under section 1322(b)(2).[24] In essence, a cramdown results.

From the discussion at the beginning of this Article,[25] it would appear that Judge Parente is favorably disposed toward the mortgagor. However, consider his decision precluding the debtor from attempting to cure a mortgage default in a plan by ruling that the mortgagee bank had a right to vacate the stay where there was no

---

[19]11 U.S.C. § 1322(c) (Supp. IV 1980) requires that a Chapter 13 repayment plan not provide for payments over a period longer than three years unless the court approves a longer period not exceeding five years. Though the provision works against the debtor in this instance, Congress' intent in enacting the provision was to eliminate practices under the old Act which resulted in extended repayment plans that were "the closest thing there is to indentured servitude . . . ." H.R. REP. NO. 595, 95th Cong., 1st Sess. 117 (1977).

[20]Retreat Inv. Corp. v. Canady (*In re* Canady), 9 Bankr. 428, 430 (D. Conn. 1981). Section 1124(2)(B) is reprinted at note 9 *supra*.

[21]*See* Act of March 3, 1933, Pub. L. No. 420, 47 Stat. 1467. This law was originally passed to provide a moratorium on dispossession of farmers by mortgagees. It was successively amended to become § 75 of Chapter VIII of the former Bankruptcy Act.

[22]*In re* Garner, 13 Bankr. 799, 801 (S.D.N.Y. 1981).

[23]*Id.*

[24]*Id.*; *see also In re* Lynch, 12 Bankr. 533 (W.D. Wis. 1981) (Wisconsin law permits redemption after foreclosure sale by sheriff but before confirmation of sale); *cf.* Advance Mortgage Corp. v. Land (*In re* Land), 14 Bankr. 132 (N.D. Ohio 1981) (where petition was filed before confirmation of sheriff's sale, debtor could cure provided the judgment in entirety was paid in full over the life of the plan).

[25]*See* notes 11-12 *supra* and accompanying text.

equity available to the debtor in the residence.[26] Judge Parente also determined that the 362(d)(2)(B) proviso that "such property is not necessary to an effective reorganization" is not applicable in a Chapter 13 case.[27]

No consideration seems to have been given by the courts that favor mortgagees to the provision of section 1322(b)(5) "for the curing of *any default within a reasonable time*."[28] The attention of those courts has focused primarily on the ability of a debtor under 1322(b)(2) to modify the rights of all other secured claims. It is axiomatic that although liens are determined by state law, the latter cannot be applied where the effect is to frustrate federal policy.[29] If the intent of Congress was to help the homeowner save his home, then certainly 1322(b)(5) should at least be as powerful a tool to aid the debtor as 1322(b)(2).

The application of section 1322(b)(5) in this context, however, raises a new issue for consideration by the court—that is, whether the debtor's proposed cure is reasonable. The following factors have been cited as relevent in resolving this issue: "(1) amount in arrears; (2) the nature of the obligation; (3) the nature of the property held as security, if any; and (4) the degree of the debtor's effort to effect prompt cure."[30] Those cases interpreting what constitutes a "reasonable time" have generally agreed that it is a fact question that must be decided on a case-by-case basis.[31]

A practical issue raised by the application of section 1322(b)(5) to the defaulting mortgagor is the financial ability of the debtor to cure the default, pay the current installments, and make payments to his other creditors which satisfy the Chapter 13 requirement of "good faith."[32] To discuss the question of good faith as applicable to a Chapter 13 proceeding would require another Article much leng-

---

[26]Roosevelt Sav. Bank v. Branch (*In re* Branch), 10 Bankr. 227, 229 (S.D.N.Y. 1981).

[27]*Id.* (citing *In re* Sulzer, 2 Bankr. 630 (S.D.N.Y. 1980)). *Contra, In re* Zellmer, 6 Bankr. 497, 500 (N.D. Ill. 1980).

[28]11 U.S.C. § 1322(b)(5) (Supp. IV 1980) (emphasis added).

[29]J. MacLachlan, Handbook of the Law of Bankruptcy § 117 (1956).

[30]*In re* Acevedo, 9 Bankr. 852, 854 (E.D.N.Y. 1981); *see also In re* King, 7 Bankr. 110 (S.D. Cal. 1980) (30 months of arrearages reasonable); Fishman v. Epps, [1978-1981 Transfer Binder] Bankr. L. Rep. (CCH) ¶ 67,438 (S.D.N.Y. May 15, 1980) (balloon payment unreasonable).

[31]*See* Home Fed. Sav. & Loan Ass'n v. Beckman (*In re* Beckman), 9 Bankr. 193 (N.D. Iowa 1981) (allowed payment of arrearages over a 30 month plan period); Coleman v. Brown (*In re* Coleman), 5 Bankr. 812 (W.D. Ky. 1980), *aff'g* 2 Bankr. 348 (W.D. Ky. 1980).

[32]*See* 11 U.S.C. § 1325(a)(3) (Supp. IV 1980).

thier than this.[33] It is, however, interesting to note that one court, in discussing the relationship between good faith and payments to unsecured creditors, indicated that the congressional mandate of receiving not less than what could be received in a Chapter 7 liquidation proceeding establishes all that is required and that "[i]ndeed, the bottom line of most Chapter 13 cases is to preserve and avoid foreclosure of the family house."[34]

In addition to the controversy regarding what constitutes a default that can be cured, and the tangential question of good faith in the proposal of a plan, consider the skirmish involving payment of interest on arrearages to be cured in installments. It would seem appropriate that the court grant adequate protection in the form of interest to be paid the mortgagee based on the delay alone. For the most part, the courts agree.[35]

Undoubtedly we shall hear more from the appellate courts in the near future. It is also possible that we may yet hear from Congress. If legislation introduced in the 1981 session is of any guidance,[36] sad tidings may impend for the consumer debtor. If so, financially overburdened homeowners must hope that interest rates decline, so as to place the individual debtor with a stable income in a more competitive position to retain his castle in stormy weather.

---

[33]The judicial opinions range in their diversity from plans being confirmed when nothing is paid to unsecured creditors to rejections being upheld when 10% has been offered to unsecured creditors. Confirmed plans: *In re* Johnson, 6 Bankr. 34 (N.D. Ill. 1980) (cure default on home, 1% to unsecured creditors); *In re* Bellgraph, 4 Bankr. 421 (W.D.N.Y. 1980) (pay secured, zero to unsecured, 100% for home mortgage). Plans lacked good faith: *In re* Harbison, 9 Bankr. 205 (N.D. Ill. 1981) (100% to secured, 10% to unsecured); *In re* Hobday, 4 Bankr. 417 (N.D. Ohio 1980) (zero to unsecured, full arrearages on home); *In re* Seman, 4 Bankr. 568 (S.D.N.Y. 1980) (pay secured, zero to unsecured, confirmation refused "for cause" instead of bad faith).

[34]*In re* Thacker, 6 Bankr. 861, 865 (W.D. Va. 1980).

[35]*In re* Marx, 11 Bankr. 819 (S.D. Ohio 1981); *In re* Gregory, 8 Bankr. 256 (S.D.N.Y. 1981). *But see In re* King, 7 Bankr. 110 (S.D. Cal. 1980).

[36]H.R. 4786, 97th Cong., 1st Sess. § 2 (1981) proposes to amend Bankruptcy Code section 109 by adding the following subsection: "(f) an individual may be a debtor under chapter 7 of this title only if such individual cannot pay a reasonable portion of his debts out of anticipated future income." This amendment would make Chapter 13 mandatory for substantially all consumer debtors who wish to declare bankruptcy.

Secured Claims Under Section 1325(a)(5)(B): Collateral Valuation, Present Value, and Adequate Protection

S. Andrew Bowman

William M. Thompson

I. Introduction

Chapter 13 of the Bankruptcy Reform Act[1] was a legislative response to the inability of the former Act[2] to meet the needs of overburdened consumer debtors.[3] Although most consumer bankrupts desired to work out repayment plans, the vast majority were opting for straight liquidation instead of Chapter XIII.[4] Especially in view of the attractiveness of repayment as opposed to liquidation,[5] Chapter XIII clearly was not adequately placing the repayment option before the consumer bankrupt.

The vague status of secured creditors under Chapter XIII has been cited as a major cause of the infrequency of resort to repayment plans under the old Act.[6] This ambiguity not only resulted in inconsistent treatment of secured claims among the several districts but also facilitated the abuse of Chapter XIII by secured creditors.[7] In some districts, secured creditors were afforded extra-ordinary powers merely as a result of their secured status, without regard to the actual value of their security interest.[8] Secured creditors were able to use the leverage inherent both in the uncertainty of the law[9] and in the security interests in personal effects[10] to coerce debtors

---

[1]11 U.S.C. §§ 1301-1330 (Supp. IV 1980).

[2]11 U.S.C. §§ 1-1103 (1976) (repealed 1979).

[3]*See* H.R. Rep. No. 595, 95th Cong., 1st Sess. 116 (1977) *reprinted in* [1978] U.S. Code Cong. & Ad. News 5963, 6076 [hereinafter cited as House Judiciary Committee Report]. The old Act was simply unable to meet the needs occasioned by the enormous growth in the incidence of consumer credit transactions in the post-World War II era. *Id.*, [1978] U.S. Code Cong. & Ad. News at 6076. Consumer credit was rare when the Act was drafted, and the Act was designed with the business debtor in mind. *Id.* at 116-17, [1978] U.S. Code Cong. & Ad. News at 6076-77.

[4]5 Collier on Bankruptcy ¶ 1300.02, at 1300-20 (15th ed. L. King 1981) [hereinafter cited as Collier].

[5]*See* House Judiciary Committee Report, *supra* note 3, at 118, [1978] U.S. Code Cong. & Ad. News at 6078-79.

[6]*See* 5 Collier, *supra* note 4, ¶ 1325.01[2][E].

[7]*See id.* ¶ 1325.01[2][E][1].

[8]*See id.* at 1325-18.

[9]*See* House Judiciary Committee Report, *supra* note 3, at 181, [1978] U.S. Code Cong. & Ad. News at 6142.

[10]*See id.* at 124, [1978] U.S. Code Cong. & Ad. News at 6085.

into paying them sums greatly in excess of the value of their security interests.[11]

The new Chapter 13, therefore, was specifically drafted to define the rights of secured creditors and to eliminate past inequities by bringing these rights into proportion with the actual value of their secured claims. Secured creditors were brought under the strict scrutiny and control of bankruptcy courts and were assured that they would receive the full economic value of their secured claims—no more and no less.[12]

This Article focuses on the two-step process whereby the secured creditor receives the value of his claim under a Chapter 13 plan.[13] First, the amount of the secured claim is determined; second, the amount is paid to the creditor in installments over the period covered by the plan. Judicial conflict abounds at both of these stages.

II. Amount of a Creditor's Secured Claim

Bankruptcy Code Section 506(a) gives a secured creditor a "secured claim" against the debtor's estate to the extent of the value of his collateral and an "unsecured claim" to the extent of any balance remaining.[14] In addition, section 1325(a)(5)(B) of the Code provides that a debtor's repayment plan under Chapter 13 may not be confirmed over the objections of the holder of a secured claim unless:

> (i) the plan provides that the holder of such claim retain the lien securing such claim; and
> (ii) the value, as of the effective date of the plan, of property to be distributed under the plan on account of such claim is not less than the allowed amount of such claim . . . .[15]

---

[11]*See id.*, [1978] U.S. Code Cong. & Ad. News at 6085.

[12]*See id.* at 181, [1978] U.S. Code Cong. & Ad. News at 6141-42.

[13]More specifically, this Article discusses problems of collateral valuation, present value determination, and adequate protection in connection with the minimum guarantees afforded secured creditors by section 1325(a)(5)(B) of the Bankruptcy Code. Problems relating to proof of value, adequate protection during the interim between filing and confirmation, and post-petition interest under section 506(b) are beyond the scope of this Article.

[14]11 U.S.C. § 506(a) (Supp. IV 1980). Consequently, if the value of the collateral exceeds the amount of the debt to the creditor, the creditor's entire claim is secured. If, however, the value of the collateral is less than the amount of the debt, the creditor's claim is bifurcated. To the extent of the collateral's value, he has a secured claim, but to the extent of the remainder of the debt he must queue with the general creditors. *See* S. Rep. No. 989, 95th Cong., 2d Sess. 68 (1978) *reprinted in* [1978] U.S. Code Cong. & Ad. News 5787, 5854 [hereinafter cited as Senate Judiciary Committee Report].

[15]11 U.S.C. § 1325(a)(5)(B) (Supp. IV 1980).

Consequently the value of the collateral securing a debt governs the extent of a secured creditor's rights under a Chapter 13 plan.

Courts have experienced substantial difficulty with collateral valuation in this context. Disparity has developed among courts regarding the appropriate measure of value. Moreover, inconsistency has developed regarding the proper time at which value should be determined. As will be shown, the lack of a consistent scheme of collateral valuation in this Chapter 13 context is a result of insufficient regard for the purpose of the valuation and the policies behind the Code.

A. *Measure of Value*

Determination of the value of collateral, hence the amount of a creditor's secured claim, has consequences beyond those pertaining to the creditor's rights under section 1325(a)(5)(B). Whether a debtor has equity in collateral for purposes of lifting the automatic stay hinges on a determination of the collateral's value.[16] Value determination is also crucial in the context of adequate protection.[17]

Because of the variety of purposes for which a value determination must be made, the Code makes it clear that "value shall be determined in light of the purpose of the valuation . . . ."[18] Moreover, legislative history indicates that a determination of value for one purpose was not intended to bind the parties in later proceedings to determine value for another purpose.[19]

The purpose of valuation under section 1325(a)(5)(B) is to ensure, as a matter of fairness, that a secured creditor who is forced to accept a repayment plan will receive the equivalent of what he would

---

[16]*See, e.g.*, Imperial Bank v. El Patio, Ltd. (*In re* El Patio, Ltd.), 6 Bankr. 518 (C.D. Cal. 1980).

[17]*See, e.g.*, ABD Fed. Credit Union v. Williams (*In re* Williams), 6 Bankr. 789 (E.D. Mich. 1980).

[18]11 U.S.C. § 506(a) (Supp. IV 1980). Section 506(a) also provides that "the proposed disposition or use" of the collateral is to be considered in determining value. *Id.* It is difficult to imagine how the proposed disposition or use of collateral would affect its value for purposes of determining the extent of a creditor's secured claim. Cases discussing value in this context have paid lip service to the "proposed disposition or use" language, but have not allowed the language to influence their determination of value. *See, e.g.*, *In re* Damron, 8 Bankr. 323, 325 (S.D. Ohio 1980). *Cf. In re* Crockett, 3 Bankr. 365, 367 (N.D. Ill. 1980) (debtor's continued use of collateral made repayment feasible and enhanced value of creditor's secured claim). The language was probably intended to apply to value determinations in other contexts. For example, if value was being ascertained for purposes of determining whether a secured creditor was adequately protected, the proposed use of the collateral would be highly relevant insofar as the use would result in future depreciation.

[19]*See* Senate Judiciary Committee Report, *supra* note 14, at 68, [1978] U.S. Code Cong. & Ad. News at 5854.

have realized if allowed to pursue the remedies available to him outside of bankruptcy.[20] In virtually all cases, therefore, the value of collateral for section 1325(a)(5)(B) purposes should be what the creditor would receive upon repossession and sale of the collateral.[21] This sum would be, simply, the net amount[22] which would be realized through a commercially reasonable sale[23] in the market to which the creditor has access.[24]

In a number of section 1325(a)(5)(B) cases, however, courts have failed to comply with the legislative mandate of determining value in light of the purpose of the valuation. *In re Willis*[25] is perhaps the most extreme example of this phenomenon. In *Willis*, the court established valuation guidelines to "eliminate the need for repetitious hearings on present and future value of collateral at . . . Chapter 13 confirmation hearings."[26] Under the guidelines, automobiles are valued at their blue book value and furniture, appliances, carpeting, and draperies are valued on a cost-less-depreciation

---

[20]*See* Chrysler Credit Corp. v. Van Nort (*In re* Van Nort), 9 Bankr. 218, 221 (E.D. Mich. 1981); *In re* Damron, 8 Bankr. 323, 325-26 (S.D. Ohio 1980).

[21]More specifically, the value should be the value the collateral would have in the creditor's hands upon his repossession. In most cases, this value would be determined by ascertaining what the creditor would receive through a commercially reasonable disposition of the collateral. *See* U.C.C. § 9-504(3) (1978). If, however, the security agreement relieves the creditor of his obligation to dispose of the collateral, the creditor should not be bound by the above standard. For example, collateral with speculative value would arguably be worth more in the creditor's hands if he were not obligated to dispose of the collateral.

Similarly, valuation should account for any going-concern value that the collateral would have in the creditor's hands. Thus, if a creditor is entitled under his security agreement to realize the going-concern value of business assets held as collateral, the value of the business assets should be determined in light of their value as part of a going-concern. It has been posited that a creditor should benefit from going-concern value even in the absence of a right outside of bankruptcy to realize such a value. *See* Comment, *Bankruptcy Reform Act of 1978: Chapter 13 Cramdown of the Secured Creditor*, 1981 Wis. L. Rev. 333, 343 & nn. 62, 65. This analysis is unsound because it places a creditor in a better position in bankruptcy than he would have been in outside of bankruptcy. *See* note 20 *supra* and accompanying text.

[22]Because the debtor's retention of the collateral relieves the creditor of expenses associated with resale, the creditor should not be allowed to realize the full amount he would receive on resale. The amount which would be received on resale must be reduced by selling costs to determine the amount to which the creditor is entitled. *See* Comment, *supra* note 21, at 342.

[23]*See* note 21 *supra*.

[24]*See In re* Klein, 10 Bankr. 657, 660 (E.D.N.Y. 1981); *In re* Damron, 8 Bankr. 323, 326 (S.D. Ohio 1980); Virginia Nat'l Bank v. Jones (*In re* Jones), 5 Bankr. 736, 739 (E.D. Va. 1980); *In re* Crockett, 3 Bankr. 365, 367 (N.D. Ill. 1980); *In re* Adams, 2 Bankr. 313, 313-14 (M.D. Fla. 1980).

[25]GMAC v. Willis (*In re* Willis), 6 Bankr. 555 (N.D. Ill. 1980).

[26]*Id.* at 557.

basis.[27] A valuation hearing is held in the "exceptional situations" in which the guidelines do not establish values acceptable to the parties in interest.[28] Even then, however, it is questionable whether a party would be allowed to prove a value in excess of that established by the guidelines.[29]

By relegating the valuation hearing to the status of a "last resort," the *Willis* court demonstrated complete disregard for the importance of value determination under Chapter 13[30] and the flexibility with which Congress intended courts to approach questions of

---

[27]*Id.* at 557-58. Specifically, the guidelines provided that value be determined in the following manner:

(a) *Automobiles*

The Average Trade-In value as shown in the N.A.D.A. Official Used Car Guide for the month in which was filed the debtor's petition for relief will be taken as present value.

(b) *Furniture*

The cost of the furniture new will be used as a base against which the following percentages shall be applied to determine present value:

Less than one year old	75%
One year to two years old	50%
Two years to three years old	25%
More than three years old	0

(c) *Appliances (including TV and Stereo)*

The cost of the appliances new will be used as a base against which the following percentages shall be applied to determine present value:

Less than one year old	80%
One year to two years old	65%
Two years to three years old	50%
Three years to four years old	25%
More than four years old	10%

(d) *Carpeting and Draperies*

The cost of the finished goods new will be used as a base against which the following percentages shall be applied to determine present value:

Less than one year old	25%
One year to two years old	10%
More than two years old	0

[28]*Id.* at 558.

[29]*Id.* at 557.

[30]*See* text accompanying notes 6-13 *supra.* For example, the *Willis* court did not believe it was necessary "to take recognition of the probability that a stove will outlast a television set." 6 Bankr. at 558. Both of these items are depreciated at the same rate under the guidelines. It is likely that a creditor with a security interest in the stove would not agree with this generalization, and rightly so. The question of value is too fact-sensitive to be resolved by a handful of general guidelines. Within practical limits, accuracy in determining value should not be sacrificed for the sake of expediency. As stated by one court, "however tempting the easier route to resolution may be, the Court finds that it cannot equate ease with equity nor fairness with fair market value." *In re* New York, New Haven & Hartford R.R., 4 Bankr. 758, 791 (D. Conn. 1980).

valuation in order to ensure proper compensation of secured creditors under section 1325.[31] The guidelines purport to approximate the value of collateral in the abstract, without regard to the actual amount a creditor could expect to receive upon repossession and sale of the collateral. No consideration is given to the market available to the creditor on resale or the actual condition of the collateral.[32]

In light of the significance afforded the value determination process under Chapter 13, it is inconceivable that Congress intended for courts to adopt inflexible valuation standards and discourage use of the valuation hearing. It is more reasonable to infer that Congress intended for the valuation hearing to acquire increased significance in promoting equitable distribution of the bankrupt's assets.

Disregard of the valuation's purpose in determining the value of collateral was evinced in *In re Miller*, in which the parties agreed that the value of an automobile for purposes of section 1325(a)(5)(B) was the debtor's replacement cost.[33] Had the creditor been a retail dealer, the debtor's replacement cost would have approximated the value the creditor would have realized upon repossession and sale of the automobile.[34] In *Miller*, however, the creditor's customary means of disposition would likely have been through the wholesale market.[35] Consequently, the section 1325(a)(5)(B) value of the automobile was lower than the parties believed, and the creditor's secured claim was inflated. Under these circumstances, the court could have appropriately refused to confirm the plan, instructed the parties on the proper means of valuation, and rescheduled the confirmation hearing.[36]

Similarly, in *In re Jordan*[37] neither party argued the proper standard for a section 1325(a)(5)(B) valuation. *Jordan* involved a question of the value of a husband's interest in entireties property for purposes of determining the amount of a judicial lien-creditor's secured claim. The creditor argued that the value should be the husband and wife's combined equity in the property; the debtor-husband contended

---

[31]This flexibility is implicit in the wording of section 506(a). *See* Virginia Nat'l Bank v. Jones (*In re* Jones), 5 Bankr. 736, 738 (E.D. Va. 1980).

[32]The current condition of the market available to the creditor is also an important consideration. *See In re* Crockett, 3 Bankr. 365, 367 (N.D. Ill. 1980).

[33]Ford Motor Credit v. Miller (*In re* Miller), 4 Bankr. 392, 393 (S.D. Cal. 1980).

[34]The replacement cost would actually exceed the value which the creditor would realize on resale by an amount equal to the creditor's selling costs. *See* note 22 *supra*.

[35]The creditor was Ford Motor Credit, a finance company.

[36]*See* Chrysler Credit Corp. v. Cooper (*In re* Cooper), 7 Bankr. 537, 543 (N.D. Ga. 1980) in which the court, unsatisfied with the parties' arguments in connection with the present value of the creditor's secured claim, requested new arguments on the issue.

[37]Jordan v. Borda (*In re* Jordan), 5 Bankr. 59 (D.N.J. 1980).

that the value was one-half the total equity.[38] The court recognized the fault in the parties' arguments, that is, that they were viewing section 1325 value without regard to the creditor's actual realization on resale.[39]

"The starting point for valuing [the creditor's] claim," stated the court, "should be an understanding of exactly what he has without, for the moment, a consideration of the bankruptcy . . . ."[40] Upon foreclosure and sale, the creditor could sell only the husband's right of survivorship and the husband's interest as a tenant in common with the wife.[41] The amount received for these rights would likely be less than the value argued by either party.[42] Nevertheless, the court adopted the debtor's measure of value, finding that measure to be "more appropriate" than the creditor's.[43] Again, it would seem to have been *most* appropriate if the court had refused to confirm the plan, instructed the parties regarding the proper measure of section 1325 value, and requested new arguments on the valuation issue.[44]

A final case which poses an interesting problem regarding section 1325(a)(5)(B) value is *In re Stumbo*,[45] in which Chrysler Credit Corporation was the assignee of a security interest in an automobile sold to the debtor by the dealer-assignor. By the terms of the assignment contract, the dealer agreed that in the event Chrysler Credit repossessed the automobile the dealer would purchase the automobile from Chrysler Credit for $10,676.29, a sum clearly in excess of the automobile's actual value. After assignment of the security interest, the debtor filed a Chapter 13 petition.

At the confirmation hearing Chrysler Credit successfully argued that the value of its secured claim was $10,676.29—the amount it would receive upon repossession and sale of the automobile to the

---

[38]*Id.* at 61-62.

[39]*Id.* at 62.

[40]*Id.*

[41]*Id.*

[42]The court referred to Newman v. Chase, 70 N.J. 254, 359 A.2d 474 (1976) in which the purchaser of the husband's interest in entireties property acquired the husband's right of survivorship and became a tenant in common with the wife. The purchaser did not, however, have the right to demand partition of the property. *Id.* at 262, 359 A.2d at 478-79. Though the purchaser was entitle to receive one-half of the rental value of the property from the wife, who retained possession, he was also obligated to account for one-half of the costs associated with the property. *Id.* at 266-68, 359 A.2d at 480-81. In *Newman*, the result of these calculations was that the purchaser received no income from the property; rather, he was obligated to account to the wife for his share of the net loss on the property. 5 Bankr. at 62 n.5.

[43]5 Bankr. at 62.

[44]*See* note 36 *supra*.

[45]7 Bankr. 939 (D. Colo. 1981).

dealer.[46] In accepting Chrysler Credit's argument, the court reasoned:

> The proposed valuation is the amount which the creditor could receive if it were granted its property under foreclosure as the cram-down provisions of § 1325(a)(5) are a simple substitution by the Congress of payment to the creditor of the amount it would receive if it in fact foreclosed upon the property.[47]

At first blush, the *Stumbo* court's argument appears to be sound because it looks to the position of the creditor upon foreclosure and sale to determine the amount of its secured claim. The decision, however, has not been followed by other bankruptcy courts.[48] The logic often used in rejecting *Stumbo* is reflected in *In re Cooper*,[49] in which the court reasoned that "'value' as used in § 506(a) . . . contemplates current fair market value of the particular collateral."[50] Because the price established by the repurchase agreement bore no relation to the value which would be established by the marketplace, it would be error to use the figure as the collateral's section 506(a) value.[51]

This argument, however, does not adequately respond to the position adopted by the *Stumbo* court. That argument, properly premised on the *purposes* of section 1325(a)(5)(B) valuation, is not adequately rebutted by the mere assertion that section 506(a) contemplates fair market value. Few would attack the result obtained in *Cooper*. In a Chapter 13 proceeding, the unfairness inherent in allowing a creditor and a third party to arbitrarily establish inflated

---

[46]*Id.* at 939-40.

[47]*Id.* at 940.

[48]*See In re* Clements, 11 Bankr. 38, 39 (N.D. Ga. 1981); *In re* Beranek, 9 Bankr. 864, 865-66 (D. Colo. 1981); Chrysler Credit Corp. v. Van Nort (*In re* Van Nort), 9 Bankr. 218, 221 (E.D. Mich. 1981); Chrysler Credit Corp. v. Cooper (*In re* Cooper), 7 Bankr. 537, 539-40 (N.D. Ga. 1980); *In re* Willis, 2 C.B.C.2d 141, 144 (W.D.N.C. 1980); Virginia Nat'l Bank v. Jones (*In re* Jones), 5 Bankr. 736, 739 n.1 (E.D. Va. 1980); *cf. In re* Fortson, 14 Bankr. 710, 711 (N.D. Ga. 1981) (failure to use value stated in repurchase agreement does not deny creditor adequate protection).

[49]Chrysler Credit Corp. v. Cooper (*In re* Cooper), 7 Bankr. 537 (N.D. Ga. 1980). *But see* Chrysler Credit Corp. v. Van Nort (*In re* Van Nort), 9 Bankr. 218 (E.D. Mich. 1981), which poses a somewhat stronger argument. The *Van Nort* court argues that the rights under a repurchase agreement are not among the interests intended to be protected by section 1325. *Id.* at 220-21. "The interest protected by § 1325(a)(5) is the right a creditor has to realize the value of certain property—the property subject to its lien." *Id.* at 221. Though this reasoning is superior to that used by the *Cooper* court, it still does not adequately explain *why* the rights under a repurchase agreement are not among the interests protected by section 1325.

[50]7 Bankr. at 539-40.

[51]*Id.* at 540.

collateral value to the detriment of the bankrupt and unsecured creditors is self-evident. To rebut the *Stumbo* court's argument, however, it is necessary to show that the purposes of section 1325(a)(5)(B) do *not* demand that the creditor be guaranteed the amount he would receive under the repurchase agreement.

Section 1325(a)(5)(B) is meant to ensure that a secured creditor will receive the equivalent of recourse to the collateral which was the inducement for extending the loan to the debtor. In other words, section 1325(a)(5)(B) protects the creditor's expectations of recovery against the debtor in the event of default. As long as only the debtor and creditor are involved, these expectations are protected by guaranteeing the creditor the amount he would receive upon repossession and sale of the collateral.

The existence of a repurchase agreement, however, alters the creditor's expectations. Though the creditor still only expects to recover the value of the collateral from the debtor, he anticipates additional recovery from the dealer in the amount by which the repurchase price exceeds the market value of the collateral in the creditor's hands. Thus, permitting the creditor to recover only the fair market value of the collateral in his hands *does* protect his expectations of recovery *as against the debtor.*

Although the creditor's expectations of recovery against the dealer are, admittedly, thwarted, the creditor is clearly in the best position to protect his bargain with the dealer. The insertion of a provision that, upon the debtor's bankruptcy, the dealer is required to tender the repurchase price to the creditor and is subrogated to the rights of the creditor would protect the creditor's expectations of recovery against the dealer *at the expense of the dealer*—not at the expense of the debtor.

B. Timing of Valuation

The Code is silent on the issue of *when* collateral should be valued for purposes of determining the amount of a creditor's secured claim. A few courts, however, have misread the Code and determined that section 1325(a)(5)(B) provides that collateral should be valued on the effective date of the plan for this purpose.[52]

Section 1325(a)(5)(B) prohibits confirmation of a plan over a secured creditor's objection unless the plan provides for payment of the equivalent of the amount of the creditor's secured claim on the

---

[52]*See, e.g.*, *In re* Klein, 10 Bankr. 657, 660-61 (E.D.N.Y. 1981); GMAC v. Willis (*In re* Willis), 6 Bankr. 555, 559 (N.D. Ill. 1980); *In re* Smith, 4 Bankr. 12, 12 (E.D.N.Y. 1980).

date of confirmation.[53] A careful reading of the section reveals that it does not address the question of when the secured claim is to be determined. It merely provides that the amount of the secured claim, whenever determined, must be paid to the creditor "as of the effective date of the plan."[54] If the payments are made in installments, the creditor is entitled to compensation for the time value of his money.[55]

The source of the difficulty encountered by some courts in interpreting section 1325(a)(5)(B) is probably the section's directive that "the value . . . of *property* to be distributed under the plan" must be determined as of the plan's effective date.[56] "Property" in the preceding passage clearly refers to the property, usually cash, which the debtor proposes to give the creditor in satisfaction of the creditor's claim.[57] A careless reading of the section, however, might lead the reader to believe that "property" refers to the collateral securing the debt.[58] Hence, the erroneous interpretation.

Why was Congress silent regarding the date of valuation for purposes of establishing the creditor's secured claim under section 1325(a)(5)(B)? This silence is clearly in accord with Congress' desire that "value" be a flexible concept.[59] Therefore, it might be argued that Congress did not intend for any single date to be used for purposes of determining a creditor's secured claim in this context. Rather, courts should be permitted to establish the appropriate valuation date on a case-by-case basis.

It must be emphasized, however, that the flexibility envisioned by Congress was flexibility depending on the purpose of the valuation and the circumstances of the case.[60] Selection of a single date

---

[53]*See* 11 U.S.C. § 1325(a)(5)(B) (Supp. IV 1980), *reprinted in* text accompanying note 15 *supra*.

[54]*Id.* § 1325(a)(5)(B)(ii).

[55]*See* text accompanying notes 115-25 *infra*.

[56]11 U.S.C. § 1325(a)(5)(B)(ii) (Supp. IV 1980) (emphasis added).

[57]*See, e.g.*, GMAC v. Hyden (*In re* Hyden), 10 Bankr. 21, 22-23 (S.D. Ohio 1980) (quoting 5 COLLIER, *supra* note 4, ¶ 1325.01[2][E][2][b][ii][A][2], at 1325-24).

[58]In *In re* Smith, 4 Bankr. 12, 12 (E.D.N.Y. 1980), for example, the court stated: "This Court finds that the value of the collateral as of the date of the confirmation hearing was $2,600. *This is also deemed to be the value as of the effective date of the plan within the meaning of section 1325(a)(5)(B)(ii)*. . . ." (emphasis added). In support of this statement the court cited 5 COLLIER, *supra* note 4, ¶ 1325.01[2][E][2][b][ii][A][3][b][i], at 1325-25. That passage in *Collier* states that "[t]he value of property to be distributed under the plan is to be ascertained as of the effective date of the plan." *Id.* Therefore, the court must have believed that "property to be distributed under the plan" meant "collateral."

[59]*See* note 31 *supra*.

[60]*See* Senate Judiciary Committee Report, *supra* note 14, at 68, [1978] U.S. CODE CONG. & AD. NEWS at 5854; House Judiciary Committee Report, *supra* note 3, at 356, [1978] U.S. CODE CONG. & AD. NEWS at 6312.

for purposes of determining a creditor's secured claim does not contravene this notion of flexibility.[61] To the contrary, logic would seem to require that valuation for a particular purpose be performed consistently. A single valuation date should be established for the purpose of determining a creditor's secured claim under section 1325(a)(5)(B).

The effect of the valuation date on the ultimate distribution of a debtor's assets must be considered in determining the date which best furthers the goals of Chapter 13. Whether the valuation date is significant in this respect depends on whether the collateral is depreciating or appreciating.[62]

Seemingly, in the case of depreciating collateral, a secured creditor would benefit at the expense of general creditors if the collateral is valued early in the proceedings. An earlier valuation would certainly increase the amount of the creditor's secured claim. However, to the extent that a delay in valuation would cause a decrease in the creditor's secured claim, the creditor would be entitled to recovery based on adequate protection.[63] The creditor therefore would receive the same amount regardless of when his secured claim was determined.

If, on the other hand, the collateral is appreciating, the timing of valuation does affect the amount a secured creditor will ultimately receive. Although the Code protects the creditor against depreciation of his collateral during the automatic stay, it does not provide a corresponding guarantee that the creditor benefit from appreciation of his collateral during the same period. Consequently, the longer the creditor delays valuing his secured claim, the greater his recovery under the Chapter 13 plan will be.

Valuing the collateral at a date other than the filing date would, therefore, allow a secured creditor to speculate at the expense of general creditors. The creditor would delay valuation as long as possible, knowing that he was protected against depreciation of the

---

[61]For example, the legislature intended for the filing date to be used to determine the amount of a creditor's secured claim for adequate protection purposes. In discussing the treatment of secured claims, the House Judiciary Committee stated: "[f]or the creditor, the bill requires that once the secured claim is determined, the court must insure that the holder of the claim is adequately protected." House Judiciary Committee Report, *supra* note 14, at 181, [1978] U.S. CODE CONG. & AD. NEWS at 6141. Adequate protection is guaranteed from the time the petition is filed. *See* 11 U.S.C. §§ 361, 362(d)(1) (Supp. IV 1980). Therefore, the secured claim must be determined as of the filing date when the court is faced with an adequate protection question.

[62]If the value of the collateral is static, of course, the date of valuation will have no effect on the distribution of the debtor's assets.

[63]*See* 11 U.S.C. § 362(d)(1) (Supp. IV 1980); GMAC v. Miller (*In re* Miller), 13 Bankr. 110, 117 (S.D. Ind. 1981).

collateral and hoping that the collateral would appreciate, thereby increasing his secured claim—a perfect hedge.

Clearly, allowing a secured creditor to speculate at the expense of general creditors is contrary to the purposes of the Code.[64] If the potential for speculation is to be eliminated, the secured creditor's claim must be established as of the date the Chapter 13 petition is filed.

Valuing a creditor's secured claim as of the filing date is desirable in other respects as well. It is sensible to use the filing date because "[t]hat is the date on which the estate [is] created and the creditor's rights [become] fixed."[65] In addition, the debtor's task of formulating a plan in compliance with section 1325 is simplified because of his ability to judge the value of a creditor's secured claim in retrospect.[66] Similarly, the court would always have the benefit of hindsight when questions arise concerning the amount of a secured claim.[67]

III. Payment of the Secured Claim

A. *Present Value*

A secured creditor's entitlement to compensation for the time value of his claim arises from the language of section 1325(a)(5)(B)(ii) which allows the court to confirm a plan only if "with respect to each allowed secured claim provided for by the plan . . . the value, as of the effective date of the plan, of property to be distributed under the plan on account of such claim is not less than the allowed amount of such claim . . . ."[68] After a thorough examination of the legislative history of Chapter 13 and 11, several courts have interpreted the language of section 1325(a)(5)(B)(ii) to require the application of present value analysis to proposed deferred payments.[69] Simply

---

[64]*See In re* Adams, 2 Bankr. 313, 314 (M.D. Fla. 1980); *cf.* Annot., 21 A.L.R. Fed. 289, 291-94 (1974) (discussing the date of valuation and the ability of secured creditors to speculate at the expense of other creditors under the old Bankruptcy Act).

[65]*In re* Adams, 2 Bankr. at 314.

[66]Bankr. R. 13-201 permits the debtor to file his Chapter 13 plan within 10 days of the filing of his petition. Determining the amount of secured claims as of the filing date would, therefore, allow the debtor to exercise hindsight in estimating the payments which should be made to secured creditors under the plan.

[67]*See* Chemical Bank v. American Kitchen Foods, Inc. (*In re* American Kitchen Foods, Inc.), 2 *Bank. Ct. Dec.* (CRR) 715, 719 (D. Me. June 8, 1976) (valuation of collateral as of filing date "involves judicial hindsight and is therefore easier, as a rule, than where neither the amount nor the condition of the collateral can be confidently forecast . . . ."). *But see* Comment, *supra* note 21, at 345 n.71 (arguing that current valuation is easier than retrospective valuation).

[68]11 U.S.C. § 1325(a)(5)(B)(ii) (Supp. IV 1980).

[69]GMAC v. Miller (*In re* Miller), 13 Bankr. 110 (S.D. Ind. 1981); GMAC v. Hyden

put, section 1325(a)(5)(B)(ii) requires that the present value of the debtor's proposed stream of future payments equal the value of the secured claim. The rationale behind this requirement is most clearly stated by the court in *In re Benford*:[70] "One need not possess a great deal of business and financial acumen to appreciate that a dollar today is worth more than a dollar tomorrow."[71]

There is no dispute that a Chapter 13 plan must provide for the time value of the secured creditor's claim to be confirmed. Nor is there any disagreement that interest payments readily provide a simple mechanism of accounting for time value.[72] The rub occurs when the parties attempt to determine the appropriate interest rate. The number of methods employed to arrive at the appropriate interest rate almost equals the number of decisions confronting this issue: the legal judgment rate;[73] the average of an arbitrary floor rate, the debtor's contract rate, and the statutory maximum rate on installment contracts;[74] the average of the debtor's contract rate and the current contract rate;[75] the contract rate;[76] the IRS rate;[77] the average of the legal judgment rate and the contract rate;[78] the prime rate;[79] the three-month United States Treasury Bill rate;[80] arbitrary rates;[81] the current contract rate;[82] and the current market rate.[83]

(*In re* Hyden), 10 Bankr. 21 (S.D. Ohio 1980); GMAC v. Anderson (*In re* Anderson), 6 Bankr. 601 (S.D. Ohio 1980); *In re* Ziegler, 6 Bankr. 3 (S.D. Ohio 1980); *In re* Crockett, 3 Bankr. 365 (N.D. Ill. 1980); GMAC v. Lum (*In re* Lum), 1 Bankr. 186 (E.D. Tenn. 1979).

[70] 14 Bankr. 157 (W.D. Ky. 1981).

[71] *Id.* at 158.

[72] 5 COLLIER, *supra* note 4, ¶ 1325.01[3][b][ii], at 1325-26.

[73] *In re* Marx, 11 Bankr. 819, 822 (S.D. Ohio 1981); *In re* Williams, 3 Bankr. 728, 732 (N.D. Ill. 1980).

[74] GMAC v. Hyden (*In re* Hyden), 10 Bankr. 21, 27 (S.D. Ohio 1980).

[75] GMAC v. Miller (*In re* Miller), 13 Bankr. 110, 113 (S.D. Ind. 1981); *In re* Kibler, 8 Bankr. 957, 960 (D. Hawaii 1981).

[76] Memphis Bank & Trust Co. v. Walker (*In re* Walker), 14 Bankr. 264, 266 (W.D. Tenn. 1981); *In re* Clements, 11 Bankr. 38, 40 (N.D. Ga. 1981); GMAC v. Anderson (*In re* Anderson), 6 Bankr. 601, 610 (S.D. Ohio 1980); *In re* Rogers, 6 Bankr. 472, 475 (S.D. Iowa 1980); *In re* Smith, 4 Bankr. 12, 13 (E.D.N.Y. 1980).

[77] *In re* Caudle, 13 Bankr. 29, 38 (W.D. Tenn. 1981) (citing 26 U.S.C. § 6621); *In re* Strong, 12 Bankr. 221, 225 (W.D. Tenn. 1981); *In re* Crotty, 11 Bankr. 507, 510 (N.D. Texas 1981); *In re* Ziegler, 6 Bankr. 3, 6 (S.D. Ohio 1980).

[78] *In re* Klein, 10 Bankr. 657, 661-62 (E.D.N.Y. 1981).

[79] Ford Motor Credit v. Miller (*In re* Miller), 4 Bankr. 392, 394 (S.D. Cal. 1980).

[80] GMAC v. Willis (*In re* Willis), 6 Bankr. 555, 557 (N.D. Ill. 1980).

[81] Chrysler Credit Corp. v. Van Nort (*In re* Van Nort), 9 Bankr. 218, 222 (E.D. Mich. 1981); *In re* Weaver, 5 Bankr. 522, 523 (N.D. Ga. 1980); *In re* Crockett, 3 Bankr. 365, 368 (N.D. Ill. 1980); GMAC v. Lum (*In re* Lum), 1 Bankr. 186, 188 (E.D. Tenn. 1979).

[82] Chrysler Credit Corp. v. Cooper (*In re* Cooper), 11 Bankr. 391, 394 (N.D. Ga. 1981).

[83] *In re* Benford, 14 Bankr. at 160.

This plethora of rates demonstrates, if not the courts' answer to "creative financing," the blatant inequities among districts in the treatment of secured creditors.

Clearly, what is needed is a uniform measurement of the appropriate interest rate to be applied to the deferred payments. To be useful, the selected measure must be susceptible of uncomplicated application to a broad range of financial transactions.

An appropriate starting point to develop a useful measure is to focus on the purpose of using present value analysis in a Chapter 13 setting. Generally, present value can be viewed as the value of money at a present date which will be paid or received in future periods. For the secured creditor, the present value of his claim is the amount he would realize if he had the full amount of his allowed secured claim in his hands on the effective date of the plan and could invest it at the prevailing rate of return for a period equal to the length of the debtor's plan.[84] Outside of bankruptcy, the prevailing rate of return or interest rate will be largely determined by: (1) preferences of individuals for current consumption over future consumption; (2) the supply of potentially productive investments; and (3) anticipated inflation.[85] These elements are reflected in the current market rate which is the result of all borrowers and lenders stating their beliefs as to each of the three elements. No one lender or borrower can affect the market rate. If a lender sets his interest rate or price of credit too high, no one will borrow from him. Conversely, if a borrower's risk is greater than the risk compensated for by the market rate, no one will lend money to him. Thus, the current market rate of interest could serve as a uniform and straightforward measure to be employed in the present value analysis of section 1325(a)(5)(B)(ii).

As in the case of valuation of collateral, the appropriate market is the market which the secured creditor confronts.[86] For example, a creditor in the business of making automobile loans could lend the money to another debtor at the prevailing interest rate charged on automobile loans if he had the money in his hands rather than restricted to the bankrupt's rehabilitation. The prime rate is immaterial because it represents the lowest rate of interest on short-term loans charged to businesses with the highest credit rating, a money market measure of the cost of capital.[87] Similarly, the legal judgment rate is immaterial because the creditor is not limited to what he

---

[84]*In re* Smith, 4 Bankr. 12, 13 (E.D.N.Y. 1980).

[85]W. Sharpe, Investments 79-84 (1981).

[86]*See* notes 20-24 *supra* and accompanying text.

[87]L. Schall & C. Haley, Introduction to Financial Management 551-52 (1977).

could collect on a judgment granted by a court but may go into the market for automobile loans and receive the rate that the market is currently willing to give lenders.

The importance of defining the creditor's relevant market becomes clear if the Chapter 13 plan is viewed as an involuntary loan where the secured creditor is forced to forgo the investment opportunities he would have had outside bankruptcy. Recognition of this inequitable situation led the court in *In re Cooper*[88] to posit that the "best method to ascertain the value of money to a creditor paid over a period of time is to determine what that particular creditor routinely receives as negotiated finance charges over the period of time with similar collateral."[89] The *Cooper* court held that the most equitable method of interest rate determination is the recognition of a rebuttable presumption that "[i]t is the *current* rate of return on negotiated loans made by the secured claimant to borrowers of a class similar to the Chapter 13 debtor which is determinative of the rate to be allowed the holder of an allowed secured claim paid in deferred terms under 1325(a)(5)(B)(ii)."[90]

Employing the prevailing interest rate, as of the effective date of the plan, which the creditor would receive for a similar financial transaction involving a comparable time period, risk, and collateral, best replicates the current market interest rate and is superior to any method which results in a lower rate. As the *Cooper* court noted, any rate lower than current market rate would fall short of complying with the adequate protection requirement of sections 361, 362(d)(1), and 363(e).[91]

The court in *In re Benford*[92] reached the conclusion that the current market rate is the optimal measure while seeming to reject the method applied in *In re Cooper*. A closer examination, however, reveals that the two courts utilized the same method of interest rate determination. The *Benford* court's announcement that the prevailing market rate on the date on which the plan becomes effective as the preferable method of interest rate determination was based on its belief that:

> The touchstone of providing present value of a claim to be paid in the future is responsiveness to current market conditions. A rule that the contract rate applies would lack such responsiveness. For instance, if a plan were confirmed

---

[88]Chrysler Credit Corp. v. Cooper (*In re* Cooper), 11 Bankr. 391 (N.D. Ga. 1981).
[89]*Id.* at 395.
[90]*Id.* at 394 (emphasis added).
[91]*Id.*
[92]14 Bankr. 157 (W.D. Ky. 1981).

> today, an installment contract entered into by the debtor two years ago would likely contain an interest rate below the present market rate.[93]

So far, the *Benford* and *Cooper* courts are in agreement. The *Benford* court attempted to distinguish *Cooper* by asserting that the use of the prevailing rate available to the creditor "would result in a debtor being charged disparate interest rates depending on the secured creditor, and thus sacrifice consistency for the sake of flexibility."[94] This distinction evaporates, however, when one recognizes that the crux of the market interest rate method depends on how each secured creditor's relevant market is defined and on what interest rate is available in that market. For example, it would make little sense to allow a mortgagee to benefit from the rate of 21% currently available to consumer lenders when the current home mortgage yield is only 17% merely to treat all secured creditors consistently. The purpose of section 1325(a)(5)(B)(ii) is to equitably provide each secured creditor what *he* would have had outside bankruptcy but for the debtor's financial demise—no more and no less.[95]

Moreover, the current market interest rate *is* the prevailing interest rate the creditor would be able to obtain in a similar transaction on the effective date of the plan. The *Benford* court implicitly recognized this fact when it gave the bank thirty days to provide proof of the market interest rate.[96] Presumably, the bank would present to the court evidence of the interest rate that it and its geographic competitors are currently negotiating on such transactions.

Thus, the adequate protection provisions of the Code require that secured creditors subject to the cram-down effects of section 1325(a)(5)(B) be given the time value of their claims. The market interest rate, as represented by the prevailing interest rate available to the creditor in a similar transaction outside bankruptcy, at the ef-

---

[93]*Id.* at 159.

[94]*Id.* at 160.

[95]One commentator contends that the market will "likely charge an additional risk premium above that reflected in the contractual interest rate" because the Chapter 13 plan exposes the creditor to more risk than a loan to another debtor. *See* Comment, *supra* note 21, at 357. This argument misdetermines the creditor's relevant market. Outside of bankruptcy the creditor presumably would undertake a similar transaction with another debtor who has collateral and risk similar to that which was possessed by the Chapter 13 debtor *before* his bankruptcy. Obviously, the creditor would not seek out other bankrupt debtors as new customers nor is the Chapter 13 debtor a part of the creditor's relevant market. Thus, the riskiness of the Chapter 13 plan is not relevant to the determination of an appropriate interest rate which would be available to the creditor outside of bankruptcy.

[96]*Id.* at 161.

fective date of the plan, is the most accurate measure of the present value of the deferred payments. With this straightforward and uniform method of calculating the present value available, this Article will explore the necessity of and means of providing adequate protection of the value of the claim throughout the life of the Chapter 13 plan.

B. Adequate Protection During the Plan

Section 1325(a)(5) provides that the court shall confirm the debtor's rehabilitation plan if (1) the secured creditor accepts the plan; (2) the secured creditor retains his lien and receives deferred payments with a present value equal to his allowed secured claim; or (3) the debtor surrenders the collateral securing the claim.[97] The requirements of section 1325(a)(5)(B) resemble the adequate protection provisions of section 361.[98] In fact, section 103(a) makes Chapter 3 applicable to Chapter 13 cases.[99] Moreover, section 1325(a)(1) requires that the debtor's plan comply with all of the provisions of Chapter 13.[100] Section 1303 grants the debtor the same rights and powers of a trustee and subjects him to the same limitations in their exercise relating to the use, sale, or lease of property other than in the ordinary course of business.[101] One such limitation, section 363(e), allows the court, upon the secured creditor's request, to prohibit or condition the use, sale, or lease of the property as is necessary to provide adequate protection of the secured creditor's interest in the property.[102]

---

[97]11 U.S.C. § 1325(a)(5) (Supp. IV 1980).

[98]*Id.* § 361 provides three nonexclusive methods of adequately protecting a secured creditor's interest in property: (1) periodic cash payments; (2) an additional or replacement lien; or (3) other relief that insures receipt of the indubitable equivalent.

[99]*Id.* § 103(a) states in part: "chapters 1, 3, and 5 of this title apply in a case under chapter 7, 11, or 13 of this title."

[100]*Id.* § 1325(a)(1).

[101]*Id.* § 1303 provides: "Subject to any limitations on a trustee under this chapter, the debtor shall have, exclusive of the trustee, the rights and powers of a trustee under sections 363(b), 363(d), 363(e), 363(f), and 363(*1*), of this title."

[102]*Id.* § 363(e) states:

> Notwithstanding any other provision of this section, at any time, on request of an entity that has an interest in property used, sold, or leased, or proposed to be used, sold, or leased, by the trustee, the court shall prohibit or condition such use, sale, or lease as is necessary to provide adequate protection of such interest. In any hearing under this section, the trustee has the burden of proof on the issue of adequate protection.

See Brickel v. Merchants Nat'l Bank (*In re* Brickel), 11 Bankr. 353, 355 (D. Me. 1981); Ford Motor Credit Co. v. Lewis (*In re* Lewis), 8 Bankr. 132, 136 (D. Idaho 1981); Chrysler Credit Corp. v. Cooper (*In re* Cooper), 7 Bankr. 537, 542 (N.D. Ga. 1980); GMAC v. Lum (*In re* Lum), 1 Bankr. 186, 187 n.1 (E.D. Tenn. 1979).

Both the provisions of section 1325(a)(5)(B) and the linkages between section 363 and Chapter 13 indicate Congress' intent that the debtor's rehabilitation should not be at the expense of his secured creditors. This intent is most clearly pronounced by the legislative history which accompanies section 1325(a)(5)(B). After noting that the enacted version of section 1325(a)(5)(B) will "significantly protect secured creditors in chapter 13," the legislative history reports:

> Of course, the secured creditors' lien only secures the value of the collateral and to the extent property is distributed of a present value equal to the allowed amount of the creditor's secured claim the creditor's lien will have been satisfied in full. Thus the lien created under section 1325(a)(5)(B)(i) is effective only to secure deferred payments to the extent of the amount of the allowed secured claim. To the extent the deferred payments exceed the value of the allowed amount of the secured claim and the debtor subsequently defaults, the lien will not secure unaccrued interest represented in such deferred payments.[103]

According to *Collier*, however, the secured creditor's interest in property need not be adequately protected in the sense of providing additional security or payments to account for depreciation in the value of the collateral or for the interest component of the deferred payments.[104]

1. *Depreciation.*—Dealing first with the problem of collateral depreciation, *Collier* states:

> Section 1325(a)(5)(B)(i) assures the holder of an allowed secured claim that its lien cannot be directly affected by a chapter 13 plan without its consent, although various indirect deleterious effects, resulting from depreciation, deterioration, damage, or loss may nonetheless occur during the extension period. There is no requirement that a chapter 13 plan provide protection to the holder of an allowed secured claim against whatever diminution in value may result to the property securing the allowed secured claim in which the lien is retained. Section 1325(a)(5)(i) [sic] merely requires a provision in the plan for the *retention* of the lien.[105]

If a Chapter 13 plan fails to adequately protect a secured credi-

---

[103] 124 CONG. REC. 32,410 (1978).

[104] 5 COLLIER, *supra* note 4, ¶ 1325.01[2][E][2][b][i], at 1325-21 to -23 & [2][E][2][b][ii][A], at 1325-23 to -25.

[105] *Id.* at 1325-22 to -23 (emphasis in original).

tor from diminutions in collateral value by granting him additional security or payments, the plan no longer shields the debtor but arms him with a sword with which the debtor may rehabilitate his financial condition at the secured creditor's expense.

Denying the secured creditor adequate protection of his security interest during the life of the plan is inconsistent with the purpose of the Code to not deprive a secured creditor of the benefit of his bargain.[106] The secured creditor is entitled to money or property to the extent of the value of his claim as of the effective date of the plan.[107] The secured party will receive the value of his original bargain only to the extent that he "is adequately protected in respect to that value over the life of the plan."[108]

A simple example will illustrate this point. Creditor lends Debtor $1,000 and takes a security interest in Debtor's VCR. At the confirmation hearing, the parties agree that the VCR has a liquidation value of $720. Thus, under section 506(a) Creditor has a secured claim of $720. In his Chapter 13 plan, Debtor provides for thirty-six monthly payments of $20 to satisfy Creditor's secured claim for $720.[109] After the end of the plan's second year, Debtor defaults. Debtor still owes Creditor $240, but the value of the collateral has depreciated to $140.[110] If Creditor reposseses the VCR and sells it for $140, he will incur a loss of $100.

Clearly, whenever a secured claim is satisfied at a rate slower than the rate of depreciation in value of the underlying collateral, the secured creditor will be deprived of the full value of his claim in

---

[106]*See* House Judiciary Committee Report, *supra* note 3, at 338-40, [1978] U.S. CODE CONG. & AD. NEWS at 6294-97. *See* Wright v. Union Central Life Ins. Co., 311 U.S. 273 (1940); Louisville Joint Stock Land Bank v. Radford, 295 U.S. 555, 560 (1935).

[107]11 U.S.C. § 1325(a)(5) (Supp. IV 1980). For methods of claim valuation, see the discussion of § 506(a) accompanying note 14 *supra.*

[108]*In re* Crockett, 3 Bankr. 365, 367 (N.D. Ill. 1980); *See* GMAC v. Miller (*In re* Miller), 13 Bankr. 110, 117-18 (S.D. Ind. 1981); ABD Federal Credit Union v. Williams (*In re* Williams), 6 Bankr. 789, 792-93 (E.D. Mich. 1980); Citizens & Southern Nat'l Bank v. Feimster (*In re* Feimster), 3 Bankr. 11, 14-15 (N.D. Ga. 1979); GMAC v. Lum (*In re* Lum), 1 Bankr. 186, 187 n.1 (E.D. Tenn. 1979). *Contra,* Associates Com. Corp. v. Brock (*In re* Brock), 6 Bankr. 105, 107-08 (N.D. Ill. 1980) (adequate protection available only between time of filing and confirmation).

[109]*See* valuation discussion accompanying notes 20-24 *supra.* In order to focus attention on the impact of depreciation on the secured creditor, this example ignores the time value of the claim which is treated separately at notes 115-25 *infra* and accompanying text.

[110]For simplicity, assume that the VCR has a useful life of two years and a salvage value of $140. Using the straight line depreciation method, the VCR would depreciate by $290 per year.

$$\frac{\$720 - \$140}{2} = \quad \$290$$

the event that the debtor defaults before the plan is completed. The debtor may, however, provide adequate protection either by adjusting the payments under the plan so that the unsatisfied claim is never more than the value of the collateral or by supplying the creditor with additional security.[111]

For example, if Debtor knew that his VCR would depreciate in value by $290 per year, he could have fully protected the value of Creditor's claim by adjusting the monthly payment by $4.17 so that Creditor would be paid $24.17 per month.[112] To guard against a loss of $4.17 if Debtor defaults when the first payment comes due, the plan should provide for an initial payment to Creditor of $4.17 on the first day of the plan. Thus, if Debtor defaults, the unsatisfied portion of the claim will exactly equal the value of the collateral.

If the debtor does not make allowance in his plan for depreciation of the collateral, the secured creditor would have cause to request the court to lift the stay.[113] The debtor would have the burden to show that the creditor's interests are adequately protected.[114]

2. Time Value.—The same adequate protection considerations apply to providing for the payment of interest over the course of the plan to account for the time value of the creditor's claim. The

---

[111]11 U.S.C. § 361(1)-(2) (Supp. IV 1980). *See, e.g., In re* Methvin, 11 Bankr. 556, 558 (S.D. Miss. 1981); Chrysler Credit Corp. v. Cooper (*In re* Cooper), 7 Bankr. 537, 542 (N.D. Ga. 1980).

[112]The monthly depreciation adjustment of $4.17 was calculated by taking the difference between the annual rate of depreciation, $290, and the annual rate of claim satisfaction, $240, and dividing by 12.

$$(\$290 - \$240) \div 12 = \$4.17$$

To assist the debtor in calculating depreciation or other financial measures, the secured creditor, who normally has greater access to such data, should provide the debtor with the relevant tables or information. *In re* Clements, 11 Bankr. 38, 41 (N.D. Ga. 1981) (court ordered the creditor to provide the debtor with loan amortization information).

[113]11 U.S.C. §§ 362(d)(1), 363(e) (Supp. IV 1980). *See, e.g.*, Chrysler Credit Corp. v. Cooper (*In re* Cooper), 7 Bankr. 537, 542 (N.D. Ga. 1980). A split has developed among the courts on the applicability of section 362(d)(2) to Chapter 13 as a discrete alternative for requesting the court to lift the stay. For a well-reasoned decision finding section 362(d)(2) applicable to Chapter 13, see GMAC v. Miller (*In re* Miller), 13 Bankr. 110, 115-16 (S.D. Ind. 1981). *Accord*, State Employees' Retirement Fund v. Gardner (*In re* Gardner), 14 Bankr. 455, 456 (E.D. Pa. 1981); Provident Sav. Ass'n v. Pannell (*In re* Pannell), 12 Bankr. 51, 53 (E.D. Pa. 1981); First Nat'l Bank of Northglenn v. Pittman (*In re* Pittman), 8 Bankr. 299, 301-02 (D. Colo. 1981); First Connecticut Small Business Inv. Co. v. Ruark, 7 Bankr. 46, 47-49 (D. Conn. 1980); *In re* Zellmer, 6 Bankr. 497, 500 (N.D. Ill. 1980); Associates Commercial Corp. v. Brock (*In re* Brock), 6 Bankr. 105, 107 (N.D. Ill. 1980). *Contra*, *In re* Garner, 4 C.B.C. 1417, 1424 (S.D.N.Y. 1981); Carpenter v. Youngs (*In re* Youngs), 7 Bankr. 69, 71 (D. Mass. 1980); Citizens & Southern Nat'l Bank v. Feimster (*In re* Feimster), 3 Bankr. 11, 14 (N.D. Ga. 1979).

[114]11 U.S.C. §§ 362(g)(2), 363(e) (Supp. IV 1980).

legislative history of section 1325(a)(5)(B) indicates that the debtor's plan of deferred payments must have a present value equal to the value of the allowed secured claim as of the date of the confirmation hearing.[115]

In section 1325(a)(5)(B)(ii), Congress recognized the necessity of compensating the creditor for the time value of his claim by including in the plan interest payments at a rate equal to the discount rate, thereby equating the value of the future stream of payments as of the confirmation date to the value of the allowed secured claim.[116] The protection afforded by section 1325(a)(5)(B)(ii) is of practical significance, however, only if the interest component of each deferred payment is secured.

Crucial to an understanding of section 1325 is the recognition that the allowed secured claim does not have a static value. The claim increases in value over the course of the plan as the secured creditor forgoes the ability to earn a return on his money while the debtor undergoes rehabilitation. As the value of the claim increases over time, so also must the amount of the deferred payments increase to satisfy the claim. The only way to guarantee that the secured creditor receives the full value of his claim, indeed to satisfy the requirements of section 1325, is by the debtor's provision in the deferred payments for the time value of the secured creditor's claim. Once the time value of the claim is accounted for, the secured creditor's realization of the full value of his claim is wholly dependent upon providing the secured creditor with additional security in the amount of the accrued interest (time value) to adequately protect the secured creditor in the event that the debtor is unable to comply with his plan.

Collier would deprive the creditor of the full value of his claim by interpreting section 1325(a)(5)(B)(i) to exclude from the protection of the lien retained by the creditor under the plan interest payments in excess of the deferred payments aggregating to the amount of the allowed secured claim.[117] This interpretation has no logical basis and is inconsistent with the legislative history accompanying section 1325(a)(5)(B) as well as with the purpose of the Code to adequately protect the interests of secured creditors.[118]

A few examples will show that it is essential for the present value of the stream of deferred payments to equal the amount of the

---

[115]124 CONG. REC. 32,410 (1978).

[116]11 U.S.C. § 1325(a)(5)(B)(ii) (Supp. IV 1980).

[117]*See* 5 COLLIER, supra note 4, ¶ 1325.01[3][b][ii], at 1325-26 to -27.

[118]*See* House Judiciary Committee Report, *supra* note 3, at 338-40, [1978] U.S. CODE CONG. & AD. NEWS at 6294-97.

allowed secured claim in order to provide the creditor with the full value of his claim. In addition, the examples will illustrate the necessity of sheltering the interest component of the deferred payments under the umbrella of the section 1325(a)(5)(B)(i) retained lien.

Consider a case in which Creditor has an allowed secured claim for $3000. If Creditor had the $3000 available outside bankruptcy, he could invest it and earn an annual return of 18%. For simplicity, assume that Debtor's plan calls for making three equal annual payments of $1379.77.[119] An amortization schedule would show that $540.00 of the payment goes to interest (time value) and $839.77 goes to principal.[120] Therefore, if Debtor defaulted when the first payment came due, the *Collier* interpretation of the Code would give Creditor a lien for $3000, the principal, but no lien for $540.00, the time value of the $3000 on which Creditor has lost the opportunity to earn an annual return of 18%. Forcing Creditor to queue up with the other unsecured creditors may be tantamount to completely depriving him of the time value of his claim.

Without adequate protection of the interest portion of the deferred payment, the requirement that the present value of the deferred payments must equal the amount of the allowed secured claim is no longer met. This is evident when a default occurs one year into the plan. Creditor will repossess the collateral covered by the lien and presumably either retain the property worth $3000 or convert it into its cash equivalent. Thus, the repossession of the collateral can be viewed as the repayment of a $3000 loan in a lump sum of $3000 after one year. The present value as of the confirmation hearing of a $3000 payment one year hence is $2542.37.[121] Obviously, the present value of this interestless "deferred payment" does not equal the allowed amount of the secured claim of $3000. Yet section 1325(a)(5)(B)(ii) requires such an agreement of values.

---

[119]The general formula for calculating present value is:

$$PV = PMT \left(\frac{1-(1+i)^{-N}}{i} \right)$$

where: PV = Present value of a debt or an account
PMT = Payment per period
i = interest rate for payment period
N = Number of periods

$$PMT = \$3000 \div \left(\frac{1-(1.18)^{-3}}{.18} \right) = \$1379.77.$$

[120]D. THORNDIKE, THORNDIKE ENCYCLOPEDIA OF BANKING AND FINANCIAL TABLES Table 2 at 202-05 (Supp. 1980).

[121]$$PV = \$3000 \left(\frac{1-(1.18)^{-1}}{.18} \right) = \$2542.37.$$

Without protecting the time value of Creditor's claim by granting him additional security, Creditor is denied the benefit of his bargain, the full value of his claim outside of bankruptcy. In effect, Debtor will have exacted an interest-free loan from Creditor unless the Code is properly construed to adequately protect Creditor's valuable property interest by providing him not only the time value of his claim but also the means to realize his compensation for lost opportunities.

To support the contention that the interest component of the deferred payments is not secured, *Collier* cites the legislative history of section 1325 which contains the language: "Thus the lien created under section 1325(a)(5)(B)(i) is effective only to secure deferred payments to the extent of the amount of the allowed secured claim."[122] *Collier* assumes that the amount of the allowed secured claim is a fixed value, but, as shown above, the value of the allowed secured claim increases over time because of its inherent time value.

Congress recognized the time value of the claim when it directed the debtor to equate the present value of the deferred payments with the amount of the allowed secured claim in the preceding sentence of the same legislative history.[123] The legislative history continues: "To the extent the deferred payments exceed the value of the allowed amount of the secured claim and the debtor subsequently defaults, the lien will not secure *unaccrued* interest represented in such deferred payments."[124]

The legislative history merely indicates that to the extent the value of the allowed secured claim has not yet been augmented by its time value, the creditor will have only the amount of the secured claim secured. For example, after one year the allowed secured claim has increased in value from $3000 to $3540 because of time value. Both the $540 representing accrued interest and the $3000 representing the original value of the claim are secured by the lien. If the Debtor had not defaulted, however, the value of the allowed secured claim would have grown to $4929.10 by the end of the third year. Of that total amount, $1929.10 represents time value. At the end of the first year, $540 of the $1929.10 has been accrued and the remainder, $1389.10, is unaccrued interest. The latter amount is, of course, not secured by the lien because after the default the creditor

---

[122] 124 Cong. Rec. 32,410 (1978).

[123] *Id.* "Of course, the secured creditors' lien only secures the value of the collateral and to the extent property is distributed of a present value equal to the allowed amount of the creditor's secured claim the creditor's lien will have been satisfied in full."

[124] *Id.* (emphasis added).

will repossess collateral worth $3540 and invest it at a return of 18% to earn that interest himself.

Thus, neither the Code nor the legislative history casts the time value of the allowed secured claim from the protection of the section 1325(a)(5)(B)(i) retained lien. In fact, the adequate protection provisions of sections 361 and 363(e) demand that the lien be supported by additional underlying collateral to assure the secured creditor of the same full value of his claim as if he had been permitted to utilize his non-bankruptcy remedies.

As in the case of depreciation, if the debtor either does not provide for the time value of the secured creditor's claim in his deferred payments or does not provide the secured creditor with additional security to protect his right to the time value of his claim, the secured creditor should request that the court lift the stay and allow the secured creditor to immediately realize the value of his claim.[125]

IV. Conclusion

There is no justification for the disparity among courts in their treatment of secured creditors under Chapter 13. This Article proposes consistent treatment of secured creditors under section 1325(a)(5) based on the purpose of that section. This purpose is simply stated: Section 1325(a)(5) is intended to guarantee the secured creditor the equivalent of recourse to his collateral on the date a Chapter 13 plan is confirmed. If problems of collateral valuation, present value, and status of the creditor during the repayment period were approached with this purpose in mind, the cases would exhibit a rational consistency currently missing in this area of the law.

---

[125] 11 U.S.C. § 362(d)(1) (Supp. IV 1980).

Note

The Continuing Vitality of *Louisville Joint Stock Land Bank v. Radford:* Persuasive Authority for Cases Declaring Retroactive Application of Section 522(f) Of the Bankruptcy Code Unconstitutional

I. Introduction

The constitutionality of retroactive legislation has traditionally been tested with strict judicial scrutiny. During the Great Depression, the United States Supreme Court struck down retroactive bankruptcy legislation as a violation of the fifth amendment in *Louisville Joint Stock Land Bank v. Radford.*[1] As a result, the Bankruptcy Act[2] was amended, and in subsequent cases the Court upheld the constitutionality of the amended Act, limiting, to a degree, *Radford.*[3] Recently, both *Radford* and succeeding decisions have been resurrected in bankruptcy cases testing the constitutionality of retroactive applications of section 522(f) of the Bankruptcy Code.[4] A number of courts have relied on *Radford* in declaring retroactive application of section 522(f) unconstitutional, while others have upheld the constitutionality of such application, either by minimizing the precedential value of *Radford* or by ignoring the decision completely.

This Note explores the *Radford* decision, its refinement in subsequent decisions, and the continuing precedential value of *Radford* as authority for declaring retroactive application of section 522(f) of the Bankruptcy Code to be in violation of the fifth amendment. This Note supports the decisions invalidating retroactive application of section 522(f) on the authority of the *Radford* decision.

---

[1]295 U.S. 555 (1935).

[2]Bankruptcy Act of 1898, 11 U.S.C. §§ 1-1103 (1976) (repealed Oct. 1, 1979, Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, § 401(a), 92 Stat. 2549) [hereinafter cited as the Act].

[3]Wright v. Union Cent. Life Ins. Co., 311 U.S. 273 (1941); Wright v. Vinton Branch of the Mountain Trust Bank, 300 U.S. 440 (1937).

[4]Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549 (codified at 11 U.S.C. §§ 101-151326 (Supp. IV 1980)). Section 522(f) appears in 11 U.S.C. § 522 (f) (Supp. IV 1980).

II. Judicial Review of Retroactive Bankruptcy Legislation: Past and Present

In 1934, Congress enacted the Frazier-Lemke Act,[5] an amendment to section 75 of the Bankruptcy Act[6] designed to protect farmers from Depression foreclosures.[7] The original Act allowed a debtor to retain mortgaged property under court-ordered supervision after obtaining a five-year stay of foreclosure proceedings. At the end of the five year period, the debtor was allowed to pay a court-determined price to redeem the property, with the creditor losing all rights under the mortgage, except for the price paid into court.[8] In the event the debtor defaulted on his payments, the Act allowed the secured creditors to enforce their interests in accordance with the law.[9] Alternatively, if all terms of the sale were complied with, the debtor was allowed to apply for his discharge.[10] Furthermore, the Act was to apply only to mortgage interests created prior to its enactment.[11]

The constitutionality of the Frazier-Lemke Act was tested by the United States Supreme Court in 1934, in *Louisville Joint Stock Land Bank v. Radford*.[12] The Court stuck down the Act, declaring its retroactive application violative of the fifth amendment as an uncompensated taking of "substantive rights in specific property acquired by the Bank prior to the Act."[13]

The following year, the Act was amended,[14] with the intention of preserving the property rights[15] held to have been taken in the *Rad-*

---

[5]Pub. L. No. 73-486, 48 Stat. 1289 (1934) (repealed 1978) [hereinafter cited as the Frazier-Lemke Act]

[6]Section 75 was added by An Act of March 3, 1933, Pub. L. No. 72-420, 47 Stat. 1470 (1933).

[7]Note, *Constitutionality of Retroactive Lien Avoidance Under Bankruptcy Code Section 522(f)*, 94 Harv. L. Rev. 1616, 1619 (1981) [hereinafter cited as Harvard Note].

[8]3 Collier on Bankruptcy ¶ 522.29 (15th ed. L. King 1979).

[9]Frazier-Lemke Act, *supra* note 5.

[10]*Id.*

[11]*Id.* at 1291.

[12]295 U.S. 555 (1935).

[13]*Id.* at 590.

[14]Frazier-Lemke Act, Pub. L. No. 74-384, § 6, 49 Stat. 943 (1935) (repealed 1978).

[15]The rights enumerated by the Court were:

> 1. The right to retain the lien until the indebtedness secured is paid.
> 2. The right to realize upon the security by public judicial sale.
> 3. The right to determine when such sale shall be held, subject only to the discretion of the court.
> 4. The right to protect its interest in the property by bidding at such sale whenever held, and thus to assure having the mortgaged property devoted primarily to the satisfaction of the debt, either through receipt of the proceeds of a fair competitive sale or by taking the property itself.

ford decision. The amended Frazier-Lemke Act was reviewed by the Supreme Court in *Wright v. Vinton Branch of the Mountain Bank.*[16] The Court in *Wright* declared the amended version constitutional, holding that it preserved three of the five rights enumerated in *Radford* and gave bankruptcy courts sufficient discretion to protect a mortgagee's interest.[17]

The scope and application of the second Frazier-Lemke Act was later questioned and upheld in *Wright v. Union Central Life Insurance Co.*[18] The Supreme Court in *Union Central* held that under the Act, "[s]afeguards were provided to protect the rights of secured creditors, throughout the proceedings, to the extent of the value of the property. There is no constitutional claim of the creditor to more than that."[19]

The Court's decisions in *Radford* and the *Wright* cases, along with its decision in *Kuehner v. Irving Trust Co.*[20] have recently been a topic of controversy in certain bankruptcy cases[21] discussing the constitutionality of section 522(f)[22] of the Bankruptcy Reform Act of 1978.[23] Section 522(f) allows the debtor in bankruptcy to avoid judicial liens and certain nonpossessory non-purchase money[24] security interests to the extent these liens impair the debtor's interest in certain personal property that would qualify as an exemption under section 522(b).[25]

> 5. The right to control meanwhile the property during the period of default, subject only to the discretion of the court, and to have the rents and profits collected by a receiver for the satisfaction of the debt.

295 U.S. at 594-95.

[16]300 U.S. 440 (1937).

[17]*Id.* at 458-68.

[18]311 U.S 273 (1941).

[19]*Id.* at 278.

[20]299 U.S. 445 (1937) (upholding congressional authority to impair contractual obligations).

[21]*See* Rodrock v. Security Indus. Bank, 642 F.2d 1193 (10th Cir. 1981), *aff'g* Jackson v. Security Indus. Bank (*In re* Jackson), 4 Bankr. 293 (D. Colo. 1980), and Rodrock v. Security Indus. Bank (*In re* Rodrock), 3 Bankr. 629 (D. Colo. 1980); Malpeli v. Beneficial Fin. Co. (*In re* Malpeli), 7 Bankr. 508 (N.D. Ill. 1980); Oldham v. Beneficial Fin. Co. (*In re* Oldham), 7 Bankr. 124 (D.N.M. 1980); Hawley v. Avco Fin. Servs. (*In re* Hawley), 4 Bankr. 147 (D. Or. 1980).

[22]11 U.S.C. § 522(f) (Supp. IV 1980).

[23]Pub. L. No. 95-598, 92 Stat. 2549 (codified at 11 U.S.C. §§ 101-151326 (Supp. IV 1980)) [hereinafter cited as the Bankruptcy Code or the Code].

[24]U.C.C. § 9-107 defines "purchase money security interest" as a security interest that is

> taken or retained by the seller of the collateral to secure all or part of its price . . . or taken by a person who by making advances or incurring an obligation gives value to enable the debtor to acquire rights in or the use of collateral if such value is in fact so used.

[25]Types of exempt property consist mainly of household goods, personal items,

Numerous cases have arisen since section 522(f) was enacted which discuss the constitutionality of the provision when applied to security interests created prior to the enactment date of the Bankruptcy Code.[26] In various cases, the secured creditors have relied on the *Radford* decision as authority for the proposition that such retroactive lien avoidance is violative of the due process or takings clause of the fifth amendment.[27] The debtors, on the other hand, along with the United States as an intervenor in support of the provision,[28] have contended that the *Wright* decisions and the Supreme Court's decision in *Kuehner v. Irving Trust Co.*, have caused such an erosion of *Radford* that it is without vitality.[29]

A. *The* Radford *Decision*

The Supreme Court's decison in *Louisville Joint Stock Land Bank v. Radford*[30] was the first in a series of cases articulating the constitutional limitations on the power of Congress to enact uniform laws of bankruptcy.[31] The issue in *Radford* was whether the Frazier-Lemke Act[32] was consistent with the United States Constitution.[33]

In 1922 and 1924, Radford, an indebted farmer, mortgaged his farm to the Louisville Joint Stock Land Bank (the Bank) to secure

---

crops, tools of the trade, and professionally prescribed health aids. *See* 11 U.S.C. § 522(f)(2)(A) to (C).

[26]There was nearly an 11 month lag between the Code's enactment date, November 6, 1978, and its effective date, October 1, 1979.

[27]The Court in *Radford* invalidated the Frazier-Lemke Act as a violation of the takings clause. 295 U.S. 555, 602 (1934). However, in Wright v. Vinton Branch of the Mountain Trust Bank, 300 U.S. 440 (1937), the Supreme Court described *Radford* as invalidating the Frazier-Lemke Act on due process grounds, rather than on an uncompensated takings basis. *Id.* at 457. This discrepancy has caused some controversy. *See, e.g.*, Note, *Lien Avoidance Under Section 522(f) of the Bankruptcy Code: Is Retrospective Application Constitutional?*, 49 FORDHAM L. REV., 615, 629 n.74 (1981); Harvard Note, *supra* note 7, at 1623, 1629. However, the majority of the bankruptcy courts relying on *Radford* to declare retroactive application of section 522(f) unconstitutional have characterized *Radford* as a "due process" decision. *See, e.g.*, cases cited note 21 *supra*. *But see* Armstrong v. United States, 364 U.S. 40, 44 (1960); Harvard Note, *supra* note 7, at 1630-32 (characterizing the *Radford* decision as relying on the takings clause).

[28]*E.g.*, Rodrock v. Security Indus. Bank, 642 F.2d 1193 (10th Cir. 1981).

[29]Rodrock v. Security Indus. Bank (*In re* Rodrock), 3 Bankr. 629, 631 (D. Colo. 1980).

[30]295 U.S. 555 (1934).

[31]Note, *Constitutional Limitations on the Bankruptcy Power: Chapter XII, Real Property Arrangements*, 52 N.Y.U. L. REV. 362, 384 (1977) [hereinafter cited as NYU Note].

[32]Frazier-Lemke Act, *supra* note 5.

[33]295 U.S. at 573.

loans of $9,000.[34] Subsequently during the Great Depression, Radford defaulted on convenants to pay taxes and to insure buildings on the farm, and also on his payments of interest and principal.[35] The Bank urged Radford to refinance his indebtedness, but he declined to do so.[36]

In June of 1933, the Bank filed a foreclosure suit and sought to appoint a receiver to take possession and control of the premises and to collect rents and profits.[37] The appointment of a receiver was denied, and the foreclosure suit was stayed upon request of a Conciliation Commissioner acting under the authority of section 75 of the Bankruptcy Act which Radford had sought to invoke. Radford attempted to effect a composition of his debts, but failed to obtain the necessary creditor acceptance.[38] Consequently, the state court, on June 30, 1934, ordered a foreclosure sale. However, the Frazier-Lemke Act was passed the preceding week, and Radford filed for relief, praying to be adjudicated a bankrupt and asking for relief under paragraphs 3 and 7 of subsection (s) of the Act.[39]

Paragraph 3 provided for the sale of the bankrupt estate back to the debtor with the consent of the lienholders. This paragraph also outlined a specific payment plan, with payments going to the credit of the lienholders as their interests appeared.[40] Paragraph 7 provided that if the mortgagee did not agree to the purchase outlined in paragraph 3, the debtor could require the court to:

> [S]tay all proceedings for a period of five years, during which five years the debtor shall retain possession of all or any part of his property, under the control of the court, provided he pays a reasonable rental annually for that part of the property of which he retains possession. . . .[41]

The Act specified that its provisions were to apply only to debts existing at the time the Act became effective.[42]

The Bank in *Radford* refused to consent to a sale of the farm under paragraph 3 of the Frazier-Lemke Act, and it objected to Rad-

---

[34] *Id.*

[35] *Id.* at 573-74.

[36] *Id.* at 574.

[37] An express covenant contained in the *Radford* mortgage agreement provided for the appointment of a receiver in the event of default.

[38] A composition was a pay-back plan proposed by the debtor. The plan could be implemented only if accepted by both a majority of the number of creditors and any creditors who collectively held over half of the amount of indebtedness.

[39] 295 U.S. at 575.

[40] Frazier-Lemke Act, *supra* note 5.

[41] *Id.* at 1291.

[42] *Id.*

ford retaining possession under the five-year stay provided by paragraph 7.[43] The federal court overruled the Bank's objections and went on to adjudicate Radford a bankrupt. Eventually, a court-appointed referee ordered, pursuant to paragraph 7, a five-year stay and left possession of the property with Radford subject to a stipulated rental payment.[44] The Bank appealed all of the referee's orders, but the orders were affirmed in both the federal district court[45] and the Sixth Circuit Court of Appeals.[46]

Throughout the lower court proceedings, and ultimately before the United States Supreme Court, the Bank argued that application of the Frazier-Lemke Act had resulted in an "oppressive and unnecessary destruction of nearly all the incidents that give attractiveness and value to collateral security."[47] The Bank contended that the Act's solely retrospective application was violative of the fifth amendment.[48] Radford, on the other hand, contended that the Act was valid as a proper exercise of Congress' constitutional power to establish uniform bankruptcy laws.[49]

1. Protection of the Mortgagor Versus the Rights of the Mortgagee.—Before announcing its decision, the Court in *Radford* discussed the historic struggle of courts and legislators to protect mortgagors while preserving the rights of mortgagees. The Court noted several judicial and legislative remedies created to provide relief to mortgagors.[50] The fate of a mortgagor had evolved from the practice of strict foreclosure[51] to the remedy of redemption as well as to statutes allowing the mortgagor to retain possession after default until foreclosure proceedings were complete.[52] However, despite the increased leniency of these remedies, the mortgagee was always to be compensated for the default by full payment of the principal plus interest.[53]

---

[43]295 U.S. at 576.

[44]*Id.* at 577-78.

[45]*In re* Radford, 8 F. Supp. 489 (W.D. Ky. 1934).

[46]Louisville Joint Stock Land Bank v. Radford, 74 F.2d 576 (6th Cir. 1935). Both the district and circuit courts also ruled in support of the constitutionality of the Frazier-Lemke Act.

[47]295 U.S. at 578.

[48]*Id.*

[49]*Id.* For a brief discussion of congressional bankruptcy power, *see generally* L. Tribe, American Constitutional Law § 5-11, at 250-52 (1978).

[50]295 U.S. at 578-81.

[51]Under the doctrine of strict foreclosure the mortgagor had no right of redemption upon default.

[52]*See* Chaplin, *The Story of Mortgage Law*, 4 Harv. L. Rev. 1 (1890) for a discussion of the history of mortgage law.

[53]*See generally* Feller, *Moratory Legislation*, 46 Harv. L. Rev. 1061 (1933).

The Court noted that historically, a mortgagee was never compelled to forego his right to insist upon full payment before giving up the security. Even when public sale superseded strict foreclosure, the mortgagee was able to insure his right to full payment by bidding at the sale.[54] Furthermore, statutes providing for retroactive application for the relief of mortgagors had only passed constitutional scrutiny when they were found to preserve the mortgagee's right to full payment through application of the security.[55] The Court in *Radford* emphasized that not until the enactment of the Frazier-Lemke Act had a mortgagee been compelled to relinquish this right to payment in full.[56]

After careful analysis, the Court concluded that prior to this enactment, no federal bankruptcy provision had ever attempted to enlarge the rights and privileges of a mortgagor as against the mortgagee, yet the Frazier-Lemke Act forced the mortgagee to surrender either the possession or the title to the mortgaged property while part of the debt remained unpaid.[57]

2. Constitutionality of the Frazier-Lemke Act.—After rejecting a tenth amendment challenge, the Court focused on the retroactive aspect of the Frazier-Lemke Act. Noting that the Act was retrospective and as "applied purport[ed] to take away rights of the mortgagee in specific property,"[58] the Court reviewed the Act in light of the constitutional constraints of the fifth amendment.[59] Although the fifth amendment does not prohibit congressional impairment of contract rights,[60] the rights at issue in *Radford* were not of a contractual nature. Rather, the rights taken by application of the Frazier-Lemke Act were "substantive rights in specific property acquired by the Bank prior to the Act."[61] As such, these rights in property were within the scope of fifth amendment protection.[62]

To determine the nature of these substantive rights, the Court looked to the property law of Kentucky, the state in which the controversy arose. There was no provision under Kentucky law permit-

---

[54]295 U.S. at 579-80.

[55]Home Bldg. and Loan Ass'n v. Blaisdell, 290 U.S. 398 (1934).

[56]295 U.S. at 579.

[57]*Id.* at 581-82.

[58]*Id.* at 589. The Court indicated that prospective application would be permissible: "The power over property pledged as security after the date of the Act may be greater than over property pledged before. . . ." *Id.*

[59]*See* Harvard Note, *supra* note 7, at 1622-24, discussing Supreme Court decisions on bankruptcy power and the fifth amendment.

[60]*See generally* Hale, *The Supreme Court and the Contract Clause*, 57 HARV. L. REV. 852 (1944).

[61]295 U.S. at 590.

[62]*Id.* at 589.

ting a mortgagor to obtain a release of the mortgaged property before foreclosure without paying his debt in full. Thus, the Court concluded that the controlling purpose of Kentucky law was for the mortgaged property to be devoted primarily to the satisfaction of the debt thereby secured.[63]

However, according to the Court, the Frazier-Lemke Act had substituted only the following alternatives for the rights the mortgagee had acquired under state law:

1) The sale authorized by paragraph 3 "would result merely in a transfer of possession to the bankrupt for six years with an otherwise unsecured promise to purchase at the end of the period for a price less than the appraised value."[64] The mortgagee would probably lose his right to *full satisfaction* of the debt by accepting a price lower than the appraised value.[65]

2) If the sale was not agreed to by the mortgagee, paragraph 7 provides that the mortgagee is compelled

> to surrender to the bankrupt possession of the property for the period of five years . . . . During that period the bankrupt has an option to purchase the farm at any time at its appraised value. . . . The mortgagee is not only compelled to submit to the sale to the bankrupt, but to a sale at such time as the latter may choose. . . . Thus the mortgagee is afforded no protection if the request [for purchase by the bankrupt] is made when values are depressed to a point lower than the original appraisal.[66]

Having left the mortgagee with only these alternatives, the Frazier-Lemke Act was held to have taken from the Bank five substantive *property* rights recognized by the law of Kentucky[67] without just compensation.[68] Therefore, the Court declared the Frazier-Lemke Act void as a violation of the fifth amendment.[69]

III. The Refinement of *Radford* by Subsequent Case Law

In the recent bankruptcy cases on section 522(f) which discuss the vitality of the *Radford*[70] decision, debtors attacking the authori-

[63]*Id.* at 590-91.
[64]*Id.* at 591.
[65]*Id.*
[66]*Id.* at 592-94.
[67]*Id.* at 594-95. For the five property interests *see* note 15 *supra*. *See also* NYU Note, *supra* note 31, at 384-85.
[68]*See* note 27 *supra*.
[69]295 U.S. at 602.
[70]Louisville Joint Stock Land Bank v. Radford, 295 U.S. 555 (1935).

ty of *Radford* have contended that three United States Supreme Court cases decided after *Radford* have had the effect of eroding the precedential value of *Radford*.[71] The cases primarily relied upon are *Kuehner v. Irving Trust Co.*,[72] *Wright v. Vinton Branch of the Mountain Trust Bank*,[73] and *Wright v. Union Central Insurance Co.*[74]

A. Kuehner v. Irving Trust Company: *Distinguishing Between the Impairment of Contract and Property Rights*

The issue in the *Kuehner* case was whether subsection (b)(10) of section 77B of the Bankruptcy Act,[75] which limited a landlord's claim under an indemnity covenant contained in a lease to an amount not to exceed three years rent, was "obnoxious to the Fifth Amendment of the Constitution."[76] As in *Radford*, the case dealt with the impairment of rights under prior agreement between the parties.

In *Kuehner*, the petitioners had entered into a 20-year lease with the United Cigar Stores Company (United). Six years after entering the lease, United declared bankruptcy. Eventually, its trustee, Irving Trust Company, rejected its lease with Kuehner. Kuehner reentered and terminated the leasehold in accordance with the lease which contained a covenant by United to indemnify Kuehner against all loss of rent from such termination. Subsequently, section 77B was enacted and United filed its petition for reorganization. The petition was approved by the court.[77]

Upon review by the Supreme Court, Kuehner attacked section 77B as violative of the constitutional limits of the bankruptcy power of Congress as well as of the fifth amendment. The petitioners relied on a statement in the *Radford* decision to demonstrate the unlawfulness of the statute as an impermissible extension of congressional bankruptcy power.[78] Kuehner asserted that *Radford* stood as persuasive authority for the principle that a statute cannot preserve specific property for the debtor's future use but rather can only protect the bankrupt from liens on future acquisitions.[79] Kuehner asserted that section 77B provided for such a preservation of property and as such was unconstitutional.[80] The Court rejected

---

[71] *See* cases cited note 21 *supra*.
[72] 299 U.S. 445 (1937).
[73] 300 U.S. 440 (1937).
[74] 311 U.S. 273 (1941).
[75] 11 U.S.C. § 207 (1976) (repealed 1978).
[76] 299 U.S. at 447.
[77] *Id.*
[78] *Id.* at 448-49.
[79] 299 U.S. at 451.
[80] *Id.*

this contention and found the statute to be within the discretionary power of Congress to effect an equitable distribution of the debtor's assets among his creditors.[81]

Nevertheless, the Court noted that Congress' power was subject to the due process guarantees of the fifth amendment.[82] Kuehner asserted that application of section 77B resulted in a destruction of his rights acquired under the lease. Kuehner conceded that these were not property rights as in *Radford*, but maintained nevertheless that the fifth amendment assured him some protection of these rights.[83] The Court, however, disagreed with this assertion and looked to *Radford* for authority. "As pointed out in [*Radford*] . . . there is, as respects the exertion of the bankruptcy power, a significant difference between a property interest and a contract, since the constitution does not forbid impairment of the obligation of the latter."[84] The Court in *Kuehner* concluded that section 77B was constitutional in that it was merely an impairment of contract rights under a lease and an impairment that was consistent with the fifth amendment and consonant with a fair, reasonable, and equitable distribution of the debtor's assets.[85]

The *Kuehner* case is easily distinguishable from *Radford* because it dealt with the contract rights of a creditor as opposed to a creditor's substantive rights in specific property.[86] Rather than representing a step "in the flight away from *Radford*"[87] *Kuehner* emphasizes the *Radford* principle that congressional bankruptcy power is subject to fifth amendment restraints serving to protect the property rights of a creditor.

B. Wright v. Vinton Branch of the Mountain Trust Bank: *Preserving Three of the Five Rights Enumerated in* Radford

The constitutionality of the Act, as amended after the *Radford* decision, was reviewed by the Supreme Court in *Wright v. Vinton Branch of the Mountain Trust Bank*.[88] In upholding the new amend-

---

[81]*Id.*

[82]295 U.S. at 589.

[83]299 U.S. at 452. *Compare* Louisville Joint Stock Land Bank v. Radford, 295 U.S. at 589 ("[u]nder the bankruptcy power Congress may discharge the debtor's personal obligation because unlike the States, it is not prohibited from impairing the obligation of contracts") *with* Harvard Note, *supra* note 7, at 1626 & n.72.

[84]299 U.S. at 451-52.

[85]*Id.* at 452.

[86]Rodrock v. Security Indus. Bank (*In re* Rodrock) 3 Bankr. 629, 633 (D. Colo. 1980).

[87]*Id.*

[88]300 U.S. 440 (1937).

ed version, the Court noted that the Act, in general, met the guidelines of *Radford.*

Writing for the Court in *Vinton Branch*, as he had done in *Radford,* Justice Brandeis interpreted *Radford* as saying that the original Frazier-Lemke Act

> [A]s applied to mortgages given before its enactment . . . violated [the fifth] amendment since it effected a substantial impairment of the mortgagee's security. The opinion enumerates five important substantive rights in specific property which had been taken.
>
> It was not held that the deprivation of any one of these rights would have rendered the Act invalid, but that the effect of the statute in its entirety was to deprive the mortgagee of his property without due process of law.[89]

The Court then noted that the authors of the new Frazier-Lemke Act had made a specific effort to preserve the substantive rights discusssed in *Radford.*[90] The amended version of Frazier-Lemke specifically preserved three of the five enumerated rights: (1) the right to retain the lien until the indebtedness thereby secured is paid,[91] (2) the right to realize upon the security by a judicial public sale,[92] and (3) the right to protect the mortgagee's interest in the property by bidding at such sale whenever held.[93]

The Bank's major challenge to the constitutionality of the amended Act rested upon the contention that the Act denied the Bank the right to determine when a judicial sale of the land could be held, subject only to the court's discretion, and that the Act

---

[89]300 U.S. 457. *See* note 27 *supra.*

[90]300 U.S. at 457. "In drafting the new Frazier-Lemke Act, its framers sought to preserve to the mortgagee all of these rights so far as essential to the enjoyment of his security." *Id.*

[91]Paragraph one of the amended Frazier-Lemke Act provided that the debtor's possession "under the supervision and control of the court," would be "subject to all existing mortgages, liens, pledges, or encumbrances" and that "all such existing mortgages, liens, pledges or encumbrances shall remain in full force and effect, and the property covered by such mortgages, liens, pledges or encumbrances shall be subject to the payment of the secured creditors as their interests may appear." Pub. L. No. 74-384, § 6, 49 Stat. 943 (1935) (repealed 1978).

[92]Paragraph three covered this right: "[U]pon request in writing by any secured creditor or creditors, the court shall order the property upon which such secured creditors have a lien to be sold at public auction." Pub. L. No. 74-384, § 6, 49 Stat. 944 (1935).

[93]Although the Act did not specifically preserve this right in its terms, the Court determined that committee reports and congressional explanations made it clear that the mortgagee was meant to have this right. 300 U.S. at 459. *See* H.R. Rep. No. 1808, 74th Cong., 1st Sess. 1, 5, 6 (1935).

therefore violated the fifth amendment.[94] The Bank complained that the new Frazier-Lemke Act gave the debtor an absolute right to a three-year stay, and that such a stay deprived it of its right to determine when the property should be sold.[95]

The Court, however, was of the opinion that the stay was not an absolute one, and that the amended version of the Act gave the court sufficient discretion under paragraphs 2 and 3 to protect the mortgagee's interest.[96] The provisions of paragraph 3 clearly indicated that the stay was not absolute in that the court could order a sale any time it appeared that the debtor could not rehabilitate himself, or if the debtor failed to comply with the provisions of the Act.[97] Paragraph 2 gave the court the additional discretionary power to order additional payments on the principal owed by the debtor if these payments were necessary to protect the creditors from loss or to conserve the security.[98] In light of these protective safeguards, the Court concluded that the amended Act could pass constitutional muster without specifically reserving the creditor's right to determine the date of judicial sale.[99]

The Bank's final argument was that the Act denied the Bank "the right to control meanwhile the property during the period of default, subject only to the discretion of the court, and to have rents and profits collected by a receiver for the satisfaction of the debt."[100] The Bank contended that the mortgagor's retention of possession was less favorable than possession by a receiver or trustee. The Court rejected this argument, noting Congress' legitimate interest in aiding victims of the Depression, and pointing out that the mortgagor, vitally interested in the property, could better serve the interests of all concerned.[101] The Court upheld the constitutionality of the amended Frazier-Lemke Act, holding that it specifically preserved three of the five rights outlined in *Radford*,[102] and gave the court sufficient discretion to protect the mortgagee's interest under the other two.[103] As such, the Act did not unreasonably modify the Bank's rights.[104]

---

[94]300 U.S. at 460.

[95]*Id.* The stay was provided for in paragraph 2 of section 75.

[96]300 U.S. at 461-64. *See* Harvard Note, *supra* note 7, at 1623.

[97]300 U.S. at 461.

[98]*Id.* at 461-62.

[99]*Id.* at 464.

[100]*Id.* at 465-66.

[101]*Id.* at 466.

[102]Rodrock v. Security Indus. Bank (*In re* Rodrock) 3 Bankr. 629, 633 (D. Colo. 1980).

[103]Harvard Note, *supra* note 7, at 1623.

[104]300 U.S. at 470.

The Court's holding in *Vinton Branch* could be viewed as a limitation upon *Radford* in that it upheld the constitutionality of the Frazier-Lemke Act although the Act only specifically preserved three of the five rights discussed in *Radford.* However, even under the *Radford* decision, the two rights that the amended Act purportedly failed to preserve had strictly been subject to the court's discretion,[105] and the Court in *Vinton Branch* purposefully noted that the amended Act gave the court sufficient discretion to protect the creditor's interest without specific reservation of these rights.[106] Moreover, in its redraft of the Frazier-Lemke Act, Congress reserved the mortgagee's right to retain his lien until full satisfaction of the debt owed, as well as the right to satisfaction of the debt through the secured property. "These are perhaps the quintessential rights of any secured creditor, and to say, therefore, that *Vinton Branch* represents an erosion of *Radford* is to disregard the significance of the rights available to secured creditors following the Frazier-Lemke amendment."[107]

C. Wright v. Union Central Life Insurance Company: *Limiting the Claim of a Secured Creditor*

Of the three cases discussed in this section, *Wright v. Union Central Life Insurance Co.*[108] is perhaps the only decision to significantly limit the *Radford* holding. As in *Vinton Branch, Union Central* dealt with the amended version of the Frazier-Lemke Act. The issue in the case was whether under paragraph 3 of the Frazier-Lemke Act, the debtor must be accorded an opportunity, at his own request, to redeem the mortgaged property at a reappraised value before the court could order a public sale.[109]

The controversy in *Wright* emerged from two seemingly inconsistent provisions contained in paragraph 3 of the amended Frazier-Lemke Act. The first stated that "upon request of any secured or unsecured creditor, or upon request of the debtor, the court shall cause a reappraisal of the debtor's property . . . and the debtor shall

---

[105] 295 U.S. at 594-95. The rights not preserved were

> 3. The right to determine when such sale shall be held, *subject only to the discretion of the court . . .*
>
> 5. The right to control meanwhile the property during the period of default, *subject only to the discretion of the court,* and to have the rents and profits collected by a receiver for the satisfaction of the debt.

Id. (emphasis added).

[106] 300 U.S. at 464.

[107] 3 Bankr. at 633.

[108] 311 U.S. 273 (1940).

[109] *Id.* at 275-76.

then pay the value so arrived at into court."[110] The second provided that "[u]pon request in writing by any secured creditor or creditors, the court shall order the property upon which such secured creditors have a lien to be sold at public auction."[111]

The Court found reconciliation of these two remedies to be a simple task if performed with a careful eye on the purpose and function of the Frazier-Lemke Act which was to aid financially burdened farmers. The Court noted further that the Act provided safeguards to protect the mortgagees' rights, and emphasized that the constitutional limit of these rights was the extent of the value of the property.[112] Having determined that the creditors' rights were protected under the Act, the Court held that the Act and any ambiguities therein must be construed in favor of the debtor.[113] Thus, the lower court decision was reversed, and the debtor was afforded an opportunity to redeem the property prior to judicial sale.[114]

Clearly, the decision of the Court to limit the constitutional claim of a mortgagee to the extent of the value of the property represents a restriction of the *Radford* holding. However, *Union Central* does establish the general principle that a secured creditor is entitled to "the constitutional minimum" of having the value of his collateral applied to the satisfaction of his debt.[115] Arguably, this right to liquidation value was the underlying purpose of the "right to realize upon the security by a public judicial sale,"[116] which right was protected in *Radford* and preserved in *Vinton Branch*. Therefore, although *Union Central* is a refinement of the *Radford* rule, it still leaves intact the principle that liens may not be entirely destroyed and are to be preserved at least to the extent of the property's value.

D. Summary

The Supreme Court's decision in *Radford* declared retroactive application of the original Frazier-Lemke Act unconstitutional as an uncompensated taking of five specific property rights from secured

---

[110]Pub. L. No. 74-384, § 6, 49 Stat. 943, 944 (1935) (repealed 1978).

[111]*Id.*

[112]311 U.S. at 278.

[113]*Id.* at 278-79.

[114]*Id.* at 281.

[115]*See* Regional Rail Reorg. Act Cases, 419 U.S. 102, 156 (1974) ("As long as creditors are assured fair value . . . for their properties, the Constitution requires nothing more."); Rosenberg, *Beyond* Yale Express: *Corporate Reorganization and the Secured Creditor's Rights of Reclamation*, 123 U. Pa. L. Rev. 509, 524-25, 528 (1975).

[116]300 U.S. at 458; 295 U.S. at 594.

creditors.[117] The *Radford* case also stands for the general rule that a substantive right in specific property cannot be *substantially* impaired by legislation enacted after the right has been created.[118] Although the subsequent Supreme Court decisions in *Kuehner, Vinton Branch,* and *Union Central* have restricted the number and nature of substantive rights to be protected, they have left intact the general *Radford* principle that a secured creditor has the right to resort to the specific property, to the extent of its value, for satisfaction of his claim.[119] This right of satisfaction cannot be destroyed by retroactive legislation.[120]

IV. *Radford* As Applied to Section 522(f)(2): Retroactive Lien Avoidance of Nonpossessory Non-Purchase Money Security Interests As Unconstitutional

In a number of recent cases dealing with the constitutionality of section 522(f) of the Bankruptcy Code, secured creditors have relied on the decision by the Supreme Court in *Radford,* as refined by subsequent cases, as authority for the proposition that retroactive lien avoidance under section 522(f)(2) is violative of the fifth amendment.[121] This section will demonstrate that the *Radford* case is both applicable and controlling precedent which mandates that retroactive application of section 522(f)(2) be declared unconstitutional.

A. *Section 522(f)(2)—Retroactive Lien Avoidance*

Section 522(f)(2) of the Bankruptcy Code provides:

> Notwithstanding any waiver of exemptions, the debtor may avoid the fixing of a lien on an interest of the debtor in property to the extent that such lien impairs an exemption to which the debtor would have been entitled under subsection (b) of this section, if such lien is—
> . . . (2) a nonpossessory, nonpurchase-money security interest in any—
>> (A) household furnishings, household goods, wearing apparel, appliances, books, animals, crops, musical instruments, or jewelry that are held

[117] 295 U.S. 555 (1934).
[118] 3 Bankr. at 632.
[119] *See* Harvard Note, *supra* note 7, at 1623.
[120] For a general discussion of the continuing precedential value of *Radford see* Gifford v. Thorp Finance (*In re* Gifford) No. 81-1174 (7th Cir. Jan. 21, 1982).
[121] *See* note 21 *supra*.

> primarily for the personal, family, or household use of the debtor or a dependent of the debtor;
>
> (B) implements, professional books, or tools, of the trade of the debtor or the trade of a dependent of the debtor; or
>
> (C) professionally prescribed health aids for the debtor or a dependent of the debtor.[122]

Briefly stated, the provision seeks to take from secured creditors all rights they possess under nonpossessory, nonpurchase-money interests in the stated types of property regardless of when these liens were created.[123]

Bankruptcy courts dealing with section 522(f) have declared almost unanimously that it was the intent of Congress that the provision be applied both retroactively and prospectively to allow debtors to avoid liens created prior to the enactment date of the Bankruptcy Code.[124] Most bankruptcy courts are also in accord that section 522(f)(2) can be applied to security interests created during the gap period between the enactment date and effective date of the Code. The rationale of such decisions is that the Code's enactment gives creditors notice that their security interests are avoidable under section 522(f)(2).[125] Yet, no such notice is given to creditors who obtain a security interest prior to the Code's enactment. Consequently, the issue arises whether retroactive application of section 522(f)(2), affecting security interests created prior to the Code's enactment date, is consistent with the Constitution.

B. Section 522(f)(2) and the Frazier-Lemke Act: A Comparison

The similarities between retroactive application of the original Frazier-Lemke Act and that of section 522(f)(2) are immediately apparent. Both provisions were enacted to rehabilitate debtors at the

---

[122]11 U.S.C. § 522(f)(2) (Supp. IV 1980).

[123]Rodrock v. Security Indus. Bank, 642 F.2d at 1197 (10th Cir. 1981) ("a complete taking of the secured creditors property interests").

[124]*See, e.g., id. Contra,* Malpeli v. Beneficial Fin. Co. (*In re* Malpeli), 7 Bankr. 508 (N.D. Ill. 1980). However, in a recent decision, the Seventh Circuit held that in order to avoid the constitutional question concerning retroactive application of section 522(f)(2), the court would construe the statute to apply prospectively only. Gifford v. Thorp Fin. Corp., (*In re* Gifford) No. 81-1174 (7th Cir. Jan. 21, 1982). The court in *Gifford* also noted the continuing vitality of the *Radford* decision. *Id.* slip op. at 7.

[125]*See, e.g.,* Seltzer v. General Fin. Corp. (*In re* Seltzer), 7 Bankr. 80, 82 (D. Colo. 1980).

expense of secured creditors.[126] Also, both statutes call for an impairment of secured creditors' interests in specific property, which were created prior to their respective enactment dates.[127]

The differences in the provisions are equally clear. The Frazier-Lemke Act affected security interests in real property, while section 522(f)(2) deals merely with personal property. This distinction is inconsequential for purposes of constitutional analysis.[128]

The extent of the impairment caused by the two statutes is substantially different, though the Frazier-Lemke Act was held by the Supreme Court in *Louisville Joint Stock Land Bank v. Radford* to have taken five specifc property rights from a mortgagee.[129] Section 522(f)(2), however, amounts to a "complete extinction" of the creditors' security interests in the collateral.[130] Yet, this difference is not a basis for distinction of the constitutional ramifications of each provision. Instead, it serves to emphasize that the constitutional restrictions placed on the Frazier-Lemke Act by the *Radford* decision must be applied to section 522(f)(2).

C. *Application of* Radford *to Section 522(f)(2)*

The *Radford* decision represents the proposition that secured creditors' rights in specific property cannot be substantially impaired by legislation enacted after the right has been created.[131] A secured creditor has the right, at minimum, to the application of the value of the collateral to the satisfaction of his debt.[132]

Retroactive application of section 522(f)(2) provides for total lien avoidance by the debtor, effectively destroying the security interests of the creditor which had vested prior to the statute's enactment date, including the right to liquidation value.[133] Recently, the Supreme Court has noted probable jurisidiction of *Rodrock v.*

---

[126] 3 Bankr. at 634 ("while the purported goal seems proper in light of 'fresh start' objectives . . . such an objective cannot be achieved at the expense of creditors. . . ."); Louisville Joint Stock Land Bank v. Radford, 295 U.S. 555, 601 (1934) ("The Frazier-Lemke Act as applied has taken from the Bank without compensation, and given to Radford, rights in specific property which are of substantial value").

[127] The original Frazier-Lemke Act, as applied, took five specific rights in the mortgaged property from the mortgagee. *See* note 15 *supra.* Section 522(f) permits complete avoidance of the secured creditors' lien in the secured property. *See* text accompanying notes 122-23 *supra.*

[128] *See* Rodrock v. Security Indus. Bank (*In re* Rodrock) 3 Bankr. 629, 634 (D. Colo. 1980).

[129] 295 U.S. 555, 594-95 (1934). *See* note 15 *supra* for the five property rights.

[130] Oldham v. Beneficial Fin. Co. (*In re* Oldham), 7 Bankr. 124, 127 (D.N.M. 1980).

[131] 3 Bankr. at 632.

[132] *See* note 115 *supra.*

[133] 3 Bankr. at 633 ("total deprivation of substantive rights in specific property").

Security Industrial Bank,[134] in which the Tenth Circuit Court of Appeals affirmed a Colorado bankruptcy court decision which held that under *Radford*, "§ 522(f)(2) could not be constitutionally applied to a creditor's security interest which came into being prior to the enactment date of the [Bankruptcy] Reform Act."[135] The lower Colorado court characterized *Radford* as "a venerable and vigorous sentinel of due process" which "teaches us that an objective [of bankruptcy law] cannot be achieved at the expense of creditors whose rights have attached prior to the enactment of the law."[136] Along with *Rodrock*, bankruptcy decisions from other states have concluded that as determined by *Radford*, the fifth amendment will not permit the "abrogation of creditors' vested rights in specific property" caused by retroactive application of section 522(f)(2).[137] They have recognized the continuing vitality of the Supreme Court's decision and have respected its constitutional guidelines. In a recent opinion, the Seventh Circuit discussed *Radford*, the subsequent cases, including *Rodrock*, and agreed that under the continuing vitality of *Radford*, retroactive application of section 522(f) would be unconstitutional.[138] However, the court avoided the constitutional ramifications of *Radford* by declaring that section 522(f) was to apply prospectively only.[139]

D. The Divergent Trend: Cases Upholding the Constitutionality of Retroactive Application of Section 522(f)

In opposition to the case law invalidating retroactive application of section 522(f)(2) there exists a line of cases upholding the constitutionality of such application.[140] Rather than focusing on the rights of secured creditors, the courts upholding retroactive application have concentrated on the congressional purpose of section 522(f)(2) to pro-

---

[134]642 F.2d 1193 (10th Cir.), *prob. juris. noted sub nom.* United States v. Security Indus. Bank, 50 U.S.L.W. 3479 (1981).

[135]3 Bankr. at 633.

[136]*Id.*

[137]*See* cases cited note 21 *supra*.

[138]Gifford v. Thorp Fin. Corp. (*In re* Gifford), No. 81-1174, slip op. at 7, 8 (7th Cir. Jan. 21, 1982).

[139]*Id.* slip op. at 11-12.

[140]*See* Campbell v. Avco Fin. Servs. (*In re* Campbell), 8 Bankr. 425 (S.D. Ohio 1981); Sweeney v. Pacific Fin. Co. (*In re* Sweeney), 7 Bankr. 814 (E.D. Wis. 1980); *In re* Goodrick, 7 Bankr. 590 (S.D. Ohio 1980); Fisher v. Liberty Loan Corp. (*In re* fisher), 6 Bankr. 206 (N.D. Ohio 1980); Curry v. Associates Fin. Servs. (*In re* Curry), 5 Bankr. 282 (N.D. Ohio 1980); Centran Bank v. Ambrose (*In re* Ambrose), 4 Bankr. 395 (N.D. Ohio 1980); Rutherford v. Associates Fin. Servs. (*In re* Rutherford), 4 Bankr. 510 (S.D. Ohio 1980).

tect needy debtors and on the reasonableness of the means chosen to effect that purpose.[141] Several courts have held the provision to be constitutional under the fifth amendment because it is not "so grossly arbitrary and unreasonable as to be incompatible with fundametal law."[142] Moreover, other decisions "have fashioned novel constitutional principles" restricting fifth amendment protection to security interests in property that a creditor would accept instead of payment.[143]

A representative example of cases upholding the constitutionality of section 522(f) is *Fisher v. Liberty Loan Corp.*[144] In *Fisher*, an Ohio bankruptcy court recognized the *Radford* rule, stating: "It has been held that a violation of the fifth amendment due process clause occurs when the retrospective application of a bankruptcy statute destroys vested property rights."[145] The court in *Fisher* discussed the nature of the property rights held to have been taken by the Frazier-Lemke Act in *Radford* and determined that these rights arose (1) from the mortgagee's belief that the secured property was worth the amount of the loan, and (2) from the mortgagee's willingness to take the secured property in lieu of the debt in case the debt was not paid.[146] On the basis of these two factors, the *Fisher* court distinguished the security interest protected in *Radford* from the interest under consideration by summarily concluding that in the case of non-purchase money security interests, the secured creditor neither believes the collateral is worth the amount of the debt nor is he willing to repossess in case of default.[147] Consequently, the court concluded that such security interests could be retroactively impaired without violating the fifth amendment.[148]

1. The Fisher *Court's Reliance on Congressional Findings.*—The court's conclusion was based in part on a congressional report which determined that non-purchase money security interests in a borrower's household goods amounted to little more than a device with which a secured creditor could threaten repossession as a means of collecting payment.[149] According to the report,

---

[141]Harvard Note, *supra* note 7, at 1620.

[142]*See, e.g.*, Fisher v. Liberty Loan Corp. (*In re* Fisher), 6 Bankr. 206 (N.D. Ohio 1980); Curry v. Associates Fin. Servs. (*In re* Curry), 5 Bankr. 282 (N.D. Ohio 1980); Centran Bank v. Ambrose (*In re* Ambrose), 4 Bankr. 395 (N.D. Ohio 1980).

[143]Harvard Note, *supra* note 7, at 1620 n.33.

[144]6 Bankr. 206 (N.D. Ohio 1980).

[145]*Id.* at 211.

[146]*Id.* at 212 (*citing In re* Carter, 56 F. Supp. 385, 388 (1944).

[147]6 Bankr. at 212-13.

[148]*Id.* at 214, *contra*, Gifford v. Thorp Fin. Corp., No. 81-1174, slip op. at 10-11.

[149]H.R. Rep. No. 595, 95th Cong., 2d Sess. 127, *reprinted in* [1978] *U.S. Code Cong. & Ad. News* 5963, 6088.

this type of collateral has little resale value and a secured creditor would rarely repossess. Rather, the creditor would prefer to leave the goods in the debtor's possession so as to afford himself collection leverage through threats of repossession.[150] Therefore, to insure the debtor's "fresh start" and to eliminate the "unfair advantage" of the secured creditor with a non-purchase money security interest in the debtor's property, Congress enacted section 522(f).[151]

Although the analysis of the *Fisher* court and of Congress may describe creditor practices in any given case, the generality and apparent conclusiveness of their findings may be misleading. Both discussions distinguish *Radford* and justify retroactive application of section 522(f) on the grounds that in the case of a non-purchase money security interest in household goods: (1) the right to repossession is little exercised because such secured property has little resale value and (2) the right to repossession is used primarily as a means of affording the creditor leverage by which he can obtain payment through threats of repossession.[152] These determinations were made essentially from the debtor's viewpoint, with the predictable consequence of diminishing the importance of the creditor's rights so as to avoid application of *Radford* and the fifth amendment.

There are several defects in such a one-sided analysis. Although the resale value of section 522(f) property may be little, or even less than the debt it secures, the retroactive taking of a security interest covering this property is still subject to constitutional scrutiny.[153] The value of the collateral is not determinative of the worth of the creditor's right. Property need not have a high dollar value for an interest in the property to be worthy of fifth amendment protection.[154]

The fact that non-purchase money security interests are taken primarily to obtain payment does not make these interests distinct from other property rights for purposes of the fifth amendment.[155] Creditors often take security interests as insurance of repayment rather than as a substitute. In this sense, the security interests are commercially valuable to creditors in that leverage guaranteeing repayment is provided. The transaction is also commercially

---

[150]*Id.*

[151]6 Bankr. at 212-13; H.R. Rep. No. 595, *supra* note 149, at 127.

[152]For a similar discussion, *see* Rodrock v. Security Indus. Bank (*In re* Rodrock), 3 Bankr. 629, 634 (D. Colo. 1980).

[153]Gifford v. Thorp Fin. Corp. (*In re* Gifford), No. 81-1174, slip op. at 10, 11 (7th Cir. Jan. 21, 1982).

[154]*Id.*

[155]*Id.*

valuable to the debtor because of his inability to obtain a loan without some sort of security.

The determinations made by the congressional report and the court in *Fisher* attempted to cast suspicion on the nature of non-purchase money security interests, yet neither denied the existence of these interests as a vested property interest recognized by law. Characterizing these legally sanctioned security interests as "oppressive"[156] to the debtor does not amount to an abrogation of the secured creditor's property rights.[157] Such a characterization does not entitle Congress to retroactively take those rights. When property rights granted to the creditor by law are taken retroactively, principles of due process embodied in case law such as *Radford* are controlling: substantive rights in specific property cannot be taken by retroactive bankruptcy legislation without violating the fifth amendment.[158]

2. The Fisher *Court's Reliance on Non-Bankruptcy Case Law.*—In its decision to uphold retroactive application of section 522(f), the court in *Fisher* also relied on the Supreme Court's decision in *Usery v. Turner Elkhorn Mining Co.*[159] The *Usery* cases involved federal legislation which required coal mine operators to aid the government in compensating coal miners who had contracted black lung disease.[160] The operators were willing to bear the burden for compensating present and future employees but they objected to the requirement that they aid employees who had terminated their employment prior to the passage of the Act.[161] The operators asserted that this retroactive aspect violated their rights of due process. Nevertheless, the Court upheld the legislation "as a rational measure to spread the costs of the employees' disabilities to those who have profited from the fruits of their labor . . . ."[162] The Court in *Usury* also held "that legislation readjusting rights and burdens is not unlawful solely because it upsets otherwise settled expectations."[163]

The *Usery* decision and the legislation at issue in that case are distinguishable from cases concerning section 522(f) for several reasons. In *Usery*, the Act at issue was based on Congress' competence to allocate the interlocking duties and rights of employers

---

[156] 6 Bankr. at 214, *quoting In re* Beck, 4 Bankr. 661, 664 (D.C. Ill. 1980).
[157] 3 Bankr. at 633-34.
[158] *Id.*
[159] 428 U.S. 1 (1976).
[160] *Id.* at 5.
[161] *Id.* at 15.
[162] *Id.* at 18.
[163] *Id.* at 16.

and employees.[164] The Court emphasized the nature of the situation before it, a cost spreading plan within an employee-employer relationship, which could indicate a restriction on the Court's analysis to similar situations. The labor-management sphere is one in which the federal role characteristically involves altering the rights and duties and contractual expectations of parties.[165] If so, the *Usery* decision would not be applicable in cases involving section 522(f) such as *Fisher*.

A further distinction between the *Usery* case and section 522(f) situations is the nature of the affected interests held by the complaining party. In *Usery* the "settled expectations" referred to by the Court were the coal mine operators' beliefs that they had incurred no liability for the disability of former employees.[166] The interest they sought to protect was past profits which the operators thought to be free from any obligation of compensation. Yet because the coal mine operators had profited from their former employees' labor during the time the employees incurred their diability, both Congress and the Court felt it rational that they share the cost.[167] In a section 522(f) case, however, the secured party is not complaining merely because he thought he had escaped some liability. A secured creditor is challenging the complete extinction of a vested property interest granted to him by state law.[168] Thus, the interest of a secured creditor is more than a settled expectation, it is a property right worthy of fifth amendment protection.[169]

3. The Fisher *Court's Discussion of Fifth Amendment Principles.*—In its decision, the *Fisher* court also discussed the general rule that for a law to violate the fifth amendment it "must be so grossly arbitrary and unreasonable as to be incompatible with fundamental law."[170] The court held that the rehabilitative purpose behind section 522(f) and the effect of its aid to the debtor demonstrated the reasonableness of the Act.[171] Yet, once again, the court adopted a rather limited view, discussing creditors' rights only to the extent that the creditors were not denied due process and avoiding the question of whether a taking had occurred.[172]

---

[164]*Id.* at 15.

[165]*See, e.g.*, J. I. Case Co. v. NLRB, 321 U.S. 332, 338 (1944).

[166]428 U.S. at 17.

[167]*Id.* at 19.

[168]Oldham v. Beneficial Fin. Co. (*In re* Oldham), 7 Bankr. 124, 127 (D.N.M 1980).

[169]3 Bankr. at 634.

[170]6 Bankr. at 213.

[171]*Id.* at 214.

[172]*Id. See also* Note, *Bankruptcy—Section 522(f) of the 1978 Code—Constitu-*

Nevertheless, it is questionable that an act which causes the total deprivation of a substantive property right created prior to its enactment date is not unreasonable. Although the motivation behind or goal of the statute may be reasonable, the means chosen to carry it out create inequity and constitutional difficulty.[173] As stated in *Radford,* such a goal cannot be achieved at the expense of creditors whose property rights have been created prior to the enactment of the law.

4. Summary of the "Upholding" Cases.—The court in *Fisher,* as well as other bankruptcy courts upholding retrospective application of section 522(f), have overlooked the precedential value of the *Radford* decision by minimizing the value of creditors' rights and concentrating on the needs of debtors and on congressional power in non-bankruptcy situations. "Theses [sic] cases, did not face squarely the impact of *Radford,* and the cases following it when applied to § 522(f)."[174] In its failure to recognize the protection afforded to a secured creditor as enunciated in *Radford,* the constitutional analysis of those courts approving retroactive lien avoidance under section 522(f) is incomplete.

V. CONCLUSION

As this Note has demonstrated, the Supreme Court's decision in *Louisville Joint Stock Land Bank v. Radford*[175] has withstood both the passage of time and judicial refinement.[176] Its directive is inescapable: Congressional bankruptcy power is subject to the fifth amendment, and bankruptcy legislation which substantially impairs pre-existing security interests is unconstitutional. Retroactive application of § 522(f)(2) of the Bankruptcy Code does more than merely impair secured claims; it provides for their complete extinction.[177] Such retroactive application of section 522(f)(2) should be declared invalid.

JANE E. MAGNUS

---

tionality of Its Application to Security Interest Pre-Drafting Enactment of the Code, 27 WAYNE L. REV. 1281, 1289-98 (1981).

[173] 3 Bankr. at 633-34.

[174] Malpeli v. Beneficial Fin. Co. (*In re* Malpeli), 7 Bankr. 508, 512 (N.D. Ill. 1980).

[175] 295 U.S. 555 (1935).

[176] The continuing vitality of *Radford* has been recognized by the Supreme Court as recently as 1960. *See* Armstrong v. United States, 364 U.S. 40 (1960). Also, the Senate acknowledged the still current principles of *Radford* in the 1978 Senate Report concerning the Bankruptcy Code when it noted the "fifth amendment protection of property interests as enunciated by the Supreme Court," citing *Radford. See* S. REP. NO. 989, 95th Cong., 2d Sess. 49, *reprinted in* [1978] U.S. CODE CONG. & AD. NEWS.

[177] Oldham v. Beneficial Fin. Co. (*In re* Oldham) 7 Bankr. 124, 127 (D.N.M. 1980).

Consumer Product Safety Commission

by Michael R. Lemov

The Consumer Product Safety Commission keeps watch over 15,000 products. Its regulatory powers are extensive.

Finally, there's a practical, comprehensive manual which explains just how this agency operates. **Consumer Product Safety Commisson** analyzes the interactions of the various statutes the agency enforces, and reviews important developments in case law.

In addition to clear explanations of the various regulatory processes, the manual also contains examples of documents the practitioner must be familiar with, such as petitions to the CPSC and substantial hazard reports. It shows the relationship of federal law to state regulations. Plus, it discusses the relationship of federal law to private actions including products liability.

Consumer Product Safety Commission is also an administrative law treatise which focuses on the regulatory activity of the agency. The author discusses the history of consumer product safety regulation by the federal government both before and after the establishment of the CPSC. Important cases and the various statutes which regulate consumer products are analyzed in depth with valuable guidance on procedural and substantive aspects of the CPSC.

The CPSC administers many other statutes such as the Flammable Fabrics Act and the Federal Hazardous Substances Act in addition to the Consumer Product Safety Act. This newly published manual is vital for determining when the interaction of these statutes is likely to affect a client's interests. Many of the arguments the manual presents can be applied as is or adapted to specific situations.

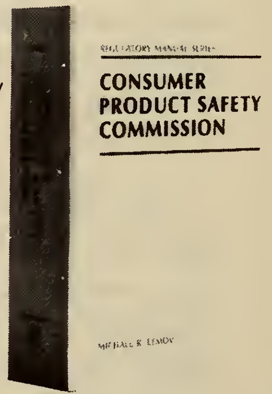
Appended materials include the text of all significant statutes including recent 1981 amendments and samples of various documents used in consumer product regulation.

1981 edition; looseleaf; approx. 800 pages; annual supplementation planned; 1 volume $75 plus $2.25 postage and handling.

About the author

Michael R. Lemov is a partner in the Washington, D.C. law firm of Leighton, Conklin, Lemov, Jacobs and Buckley. His practice focuses primarily on representation before courts, as well as on representation in the Congress of client's interests in federal legislation.

Contents



The Consumer Product Safety Act: An Overview; History of Federal Product Safety Legislation; CPSC Organization and Functions; Commission Jurisdiction; Consumer Product Safety Standards and Bans; Substantial Product Hazards and Product Recall; Imminent Hazard Authority; Enforcement of Commission Rules and Orders; Imports and Exports; Petitions for Product Safety Rules; Judicial Review of Commission Actions; Information Collection and Dissemination; Effect of CPSA on Private Causes of Action; Relationship to State and Other Federal Laws, The Transferred Acts: Flammable Fabrics, Federal Hazardous Substances, Poison Prevention Packaging;Commission Planning and Priorities.

Name ______________________

Address ______________________

City ____________ State ____________ Zip ________

☐ Please send me **CONSUMER PRODUCT SAFETY COMMISSION.** Purchase includes my order for future upkeep service. Add appropriate sales tax. $75.00 plus $2.25 postage and handling.

☐ Have your representative call on me.

☐ Charge my Shepard's account no. ____________

☐ Bill me. Bill firm ______________________

Orders subject to acceptance in Colorado Springs. Terms available, no carrying charges.

Please send the books checked below. My order includes future materials such as pocket parts, supplements, replacement pages, advance sheets and replacement, revised, recompiled or split volumes, future new editions and additional companion or related volumes. At any time, I will be free to cancel or change my order for upkeep services. Prices subject to change without notice.

Shepard's/ McGraw-Hill

P. O. Box 1235, Colorado Springs Colorado 80901 ★ (303) 475-7230

ETHICAL PROBLEMS IN FEDERAL TAX PRACTICE

By Bernard Wolfman
and James P. Holden

The various roles of the lawyer in federal tax practice pose concrete ethical questions which are carefully explored in this text. The issues implicated in return preparation, audit and litigation, tax planning, and policy formulation are examined in light of the authorities governing conduct in these settings.

Additional areas of professional responsibility involving the role of accountants, conflicts of interest, confidentiality, tax shelter opinions, malpractice, and special problems facing government lawyers, are probed concisely and analytically.

This unique new text combines important excerpts from law review articles, leading cases and rulings, Treasury regulations, and ABA and AICPA guidelines, along with the authors' commentaries, to examine and clarify the difficult, and often very subtle, issues that recur in federal tax practice.

$18.00* | **366 pages**
 | **softbound**

CONTEMPORARY LEGAL
EDUCATION SERIES

MICHIE
BOBBS-MERRILL
P. O. Box 7587,
Charlottesville, Va. 22906

*Plus shipping, handling and tax where applicable